United States Department of State
and the Broadcasting Board of Governors

Office of Inspector General

DEC 15 2009

INFORMATION MEMO FOR THE SECRETARY

FROM: OIG/DIG – Harold W. Geisel

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

An independent certified public accounting firm, Kearney & Company, P.C., was engaged to audit the financial statements of the U.S. Department of State (Department) as of September 30, 2009, and for the year then ended, to provide a report on internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations, 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 and regulations it tested. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; Office of Management and Budget audit guidance; and the *Financial Audit Manual*, issued by the Government Accountability Office and the President's Council on Integrity and Efficiency.

In its audit of the Department, Kearney & Company, P.C., was unable to obtain sufficient evidential support for the amounts presented in the FY 2009 Combined Statement of Budgetary Resources. Because of this limitation on its scope of work, Kearney & Company, P.C., was unable to give an opinion on the Combined Statement of Budgetary Resources.

In addition, Kearney & Company, P.C., was 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.

Except for the effects of such adjustments, if any, as might have been determined to be necessary had Kearney & Company, P.C., been able to obtain evidential material to enable it to perform audit procedures to satisfy itself that property and equipment were free of material misstatement, Kearney & Company, P.C., found

- the Consolidated Balance Sheet, Consolidated Statement of Net Cost, and Consolidated Statement of Changes in Net Position were presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles,
- material weaknesses[1] in internal control, and
- instances of reportable noncompliance with laws and regulations tested, including instances in which the Department's financial management systems did not substantially comply with FFMIA.

Kearney & Company, P.C., is responsible for the attached auditor's report, which includes the Report of Independent Auditors, the Independent Auditor's Report on Internal Control, and the Independent Auditor's Report on Compliance and Other Matters, dated December 14, 2009, 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 and compliance with laws and regulations, including whether the Department's financial management systems substantially complied with FFMIA.

Comments on the auditor's report from the Bureau of Resource Management are also attached to this memorandum.

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

Attachments: As stated.

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[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.

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REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying consolidated balance sheet of the U.S. Department of State (Department) as of September 30, 2009, and the related consolidated statements of net cost and changes in net position for the year then ended. We were also engaged to audit the combined statement of budgetary resources for the year ended September 30, 2009. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

The Department's financial statements as of September 30, 2008, were audited by other auditors, whose report, dated December 12, 2008, expressed an unqualified opinion on those statements. We audited the adjustments described in Note 20 that were applied to restate the 2008 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

Except as described in the following paragraphs, we conducted our audit in accordance with auditing standards generally accepted in the United States of America; 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. 07-04, as amended, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion on the consolidated balance sheet and statements of net cost and changes in net position.

The Department was unable to provide timely and competent evidential material to enable us to perform audit procedures to satisfy ourselves that the combined statement of budgetary resources for the year ended September 30, 2009, was free of material misstatements within the timeframes established by OMB. Our audit work identified issues related to the systems, processes, and internal controls supporting financial reporting and related processes, as well as key account balances. As a result of these limitations, we were unable to obtain sufficient evidential support for the amounts presented in the FY 2009 combined statement of budgetary resources.

The Department was also unable to provide timely and complete evidential material to enable us to perform audit procedures to satisfy ourselves that the property and equipment balance was free of material misstatements. Our work identified issues related to land valuation; identification and valuation of assets and liabilities under capital leases; completeness and accuracy of real property;

and existence, completeness, and valuation of personal property. As a result of these limitations, we were unable to obtain sufficient evidential support for property and equipment amounts presented in the FY 2009 consolidated balance sheet and consolidated statement of net position.

As discussed in Note 20 to the FY 2009 financial statements, the Department restated its FY 2008 financial statements to correct errors identified during the course of the FY 2009 financial statement audit related to classification and amounts reported as environmental liabilities and the valuation of two specific land holdings received from host governments in the mid 1900s.

Because of the matters discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the combined statement of budgetary resources. We were unable to obtain sufficient and competent evidential matter related to the Department's property and equipment balance as of September 30, 2009. We cannot determine if the consolidated balance sheet and statement of changes in net position presented are free from material misstatement. In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to the property and equipment balance, the consolidated balance sheet as of September 30, 2009, and the related statements of net cost and changes in net position for the year then ended, including the accompanying notes, present fairly, in all material respects, the financial position of the Department as of September 30, 2009, and its net cost of operations and changes in net position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Department's Management's Discussion and Analysis, Required Supplementary Information (including stewardship information), and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements. Such information has not been subjected to auditing procedures, and accordingly, we express no opinion on it. We were unable to apply certain procedures prescribed by professional standards to the information within the timeframes established by OMB because of the limitations on the scope of our audit of the financial statements.

In accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have also issued reports, dated December 14, 2009, on our consideration of the Department's internal control over financial reporting and compliance, and on our tests of its compliance with certain provisions of laws, regulations, and other matters for the year ended September 30, 2009. The purpose of the 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 the internal control over financial reporting or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, and should be considered in assessing the results of our audit.

Kearney & Company

December 14, 2009

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL

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

We were engaged to audit the financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2009, and have issued our report dated December 14, 2009. Our report on the consolidated balance sheet of the Department and the related consolidated statement of changes in net position for the year then ended was qualified due to the Department's inability to provide timely and competent evidential material to enable us to perform audit procedures to satisfy ourselves that the property and equipment (P&E) balance was free of material misstatement. In addition, the report states that because of the matters discussed therein, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the combined statement of budgetary resources for the year ended September 30, 2009.

The management of the Department is responsible for establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met.

In planning and performing our work, we considered the Department's internal control over financial reporting and compliance by obtaining an understanding of the design effectiveness of the Department's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of the Department's controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal controls. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting and compliance or on management's assertion on internal control included in Management's Discussion and Analysis.

We limited our internal control testing to those controls necessary to achieve the control objectives of Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended, control objectives that provide reasonable, but not absolute assurance, that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in compliance with laws governing the use of budget authority, government-wide policies and laws identified in Appendix E of OMB Bulletin No. 07-04, as amended, and other laws and regulations that could have a direct and material effect on financial statements. We did not test all internal controls relevant to operating objectives, as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraphs and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

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 a 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. We consider the following deficiencies in the Department's internal control to be material weaknesses.

Material Weaknesses

I. Environmental Liability Restatement

The Department consolidates the International Boundary and Water Commission, United States and Mexico, U.S. Section (USIBWC), into its financial statements. For the year ended September 30, 2008, USIBWC reported an environmental remediation liability of approximately $381 million. The Department did not have a process in place to analyze and evaluate USIBWC's financial information prior to its incorporation in the consolidated financial statements. During the course of our FY 2009 audit, we questioned the appropriateness of this recognition in relation to GAAP. As a result of our inquiries, the Department restated its prior year financial statements and eliminated the environmental liability initially reported by USIBWC.

The recorded liabilities resulted from two court cases requiring the USIBWC to either construct a new sanitary treatment facility or upgrade an existing treatment facility. Neither court case identified the existence of environmental contamination that required cleanup or removal. Additionally, neither ruling assessed fines, penalties, or damages. Both rulings required USIBWC to expend funds for construction of an asset, which would then be reported as P&E. In one case, USIBWC executed a Memorandum of Understanding with a local jurisdiction in which the local jurisdiction would be responsible for construction of the plant, would obtain funding for the plant's construction, and would own the plant. The local jurisdiction obtained a grant to fund construction, and construction was approaching substantial completion at September 30, 2008.

The Department submitted a Technical Inquiry regarding this issue to the Federal Accounting Standards Advisory Board (FASAB). FASAB concluded that a liability did not exist in either case.

II. Property and Equipment

The Department reported approximately $12 billion in net P&E on its FY 2009 financial statements, about 20 percent of total assets. The Department's internal control structure exhibited several deficiencies that negatively affect the Department's ability to account for real and personal property in a complete, accurate, and timely manner. Weaknesses in property were initially reported in the audit of the Department's FY 2005 financial statements, and subsequent audits. Based on the pervasiveness of the deficiencies in internal control identified, and the related risk of a material misstatement in the financial statements, we assess the Department's property accounting challenges as a material weakness in FY 2009. The combination of these control deficiencies results in more than 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. The individual deficiencies we identified are discussed below:

- <u>Land Valuation</u> – The Department reported $2.2 billion of land and land improvements in FY 2008. As part of our audit of reconciliation procedures and controls in the area of real property, we identified errors in the calculation of the value of land owned by the Department. The Department estimated values for older land parcels because historical cost records were incomplete or missing. The estimation method consisted of obtaining appraisals and discounting the appraisal values back to the date of acquisition using local general inflation factors and currency exchange fluctuations. The Department applied this method regardless of the method of acquisition, i.e., purchase, gift, construction, or trade.

  Included in the Department's land balance, carried forward from years prior to 2008, were nine individual parcels of land with a combined value of $456 million. The nine parcels related to two specific prior period transactions. The Department had erroneously recorded these parcels without discounting estimated values back to the year of acquisition consistent with the Department's stated policy. Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment,* requires fair market valuation at the time of the gift. The Department processed a restatement to write-down the value of these land parcels to a combined value of $58 million.

- <u>Capital Leases</u> – The Department manages approximately 7,500 real property leases. SFFAS No. 6 requires an analysis of leases for capitalization based on four criteria. In determining leases that qualify as capital leases under GAAP, the Department did not apply one of the four capital lease evaluation criteria – net present value of minimum lease payments in excess of 90 percent of fair market value. If this criterion is met, the Department would record an asset under capital lease, typically for the net present value of the minimum lease payments. The lack of analysis of capital leases in accordance with

SFFAS No. 6 produced an uncertainty as to the Department's accurate valuation of assets under capital leases.

- Completeness and Accuracy of Real Property – The Department reported a net value of $11 billion in real property assets as of September 30, 2009. Real property primarily consisted of facilities used for U.S. diplomatic missions abroad. The Department has not completed a reconciliation of the overseas real property listed in its general ledger to the properties tracked in its overseas real property management system. Efforts to reconcile real property records for a sample of international posts identified numerous errors and reconciling items. The lack of reconciliation increases the risk that errors may occur and remain undetected and uncorrected for extended periods of time.

- Accounting for Personal Property – The Department reported over $700 million in net personal property as of September 30, 2009. The Department's internal control structure contained several deficiencies related to the timeliness and accuracy of accounting for acquisitions and disposals, the adequacy of physical inventory controls, and the completeness and accuracy of contractor-held property inventories. The combination of these deficiencies contributed to the uncertainty of the Department's personal property balances.

- Accounting for Construction-in-Progress (CIP) – The Department processed approximately $1.8 billion in CIP activity during FY 2009. The Department's internal control structure did not ensure that only valid project costs were capitalized. In addition, the internal control structure did not ensure accurate recording of contractor retainage or identification of lagging costs at the time of a project's substantial completion and transfer into service.

III. Financial Reporting

The Department does not have adequate systems, processes, or controls in place to support the completion of a financial statement audit to meet OMB deadlines. For the FY 2009 audit, we disclaimed an opinion on the statement of budgetary resources because the Department was unable to provide timely and competent documentation prior to OMB's deadline. The FY 2009 audit also identified material adjustments and uncertainties related to Environmental Liabilities and P&E. Combined with the Department's non-automated, manually intensive financial statement process and lack of support for journal entries generated by that manual process, this resulted in a material weakness. In addition, key year-end financial reporting deadlines were not met for the production of draft financial statements, supporting journal vouchers, trial balances, and crosswalks. The Department issued multiple versions of the draft financial statements within four days, and the final statement of budgetary resources and supporting detail was submitted 11 days late during the 30-day extension period. Accordingly, this led to delays in conducting audit procedures and ultimately the inability to render an opinion on the statement of budgetary resources.

The Department compiles its financial statements through a multi-step process using a combination of manual and automated procedures. The existing accounting system does not have the ability to fully compile the required financial statements and related reports. The necessary data is extracted from multiple systems and source files and sometimes manually keyed into crosswalk templates (i.e., Excel spreadsheets), which ultimately populate the financial statements. To prepare the balance sheet and the consolidated statements of net costs and net position, over 100 manual journal vouchers containing over 1,100 debit/credit combinations with a value of approximately $80.4 billion were recorded.

The non-automated, manually intensive nature of the financial statement compilation process, particularly for the statement of net cost and statement of budgetary resources, resulted in further delays in the production of final financial statements due to the identification of additional adjustments. The lack of a budgetary financial reporting system that is integrated with the financial management system general ledger forces the Department to use an extremely manual, labor-intensive process to develop the statement of budgetary resources. During the compilation process, multiple manual adjustments are required to be posted. A total of 2,602 manual adjustments with a net negative value of $1.4 billion and an absolute value of $202.4 billion were required to reconcile the statement of budgetary resources with the Report on Budget Execution and Budgetary Resources (SF-133). Despite these adjustments, $28.2 million (absolute value) of differences remained between the statement of budgetary resources and the SF-133s.

When accounting for financial transactions, the Department processes an excessive amount of data manually. Manual adjustments are prone to human error, require an increased measure of internal control and review, and increase the likelihood of errors in the statements.

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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. Accounts Payable Accruals

The Department does not have adequate internal controls in place to ensure that accounts payable accruals are reasonably estimated. GAAP requires an estimate of goods and services received before year-end for which an invoice was not recorded in the accounting records at year-end. The Department uses two different methodologies to estimate domestic and international non-Federal accounts payable accruals. The Department did not prepare an accrual for Federal accounts payable. The Department had no methodology for estimating an accrual for Federal goods and services received but not billed, and could not provide support to demonstrate that an accrual was unnecessary. The audit produced an estimated adjustment of approximately $80 million based on an analysis of recorded transactions and posting types. The Department recorded this audit adjustment in the financial statements.

In addition, our audit procedures identified anomalies within the Department's overseas accrual methodology. The revised estimate resulted in an audit adjustment of approximately $28 million based on an analysis of the subsequent year's transactions, invoice descriptions, and transaction dates.

The Department does not validate the domestic and international accrual models with actual transaction data to determine the accuracy of the models' outputs. This lack of formal validation limits the Department's ability to ensure that its current methodology is consistent with actual events. Audit procedures identified errors in both the domestic and international accrual estimates.

II. Validity and Accuracy of Unliquidated Obligations

The Department's internal controls are not sufficient to ensure that unliquidated obligations (ULO) are consistently and systematically evaluated for validity and deobligation. Weaknesses in controls over ULOs were initially reported in the audit of the Department's FY 1997 financial statements and subsequent audits. ULOs represent the cumulative amount of orders, contracts, and other binding agreements not yet outlayed. The Department has over $13 billion in ULO balances as of year-end FY 2009 covering a broad spectrum of budgetary authority including annual, multi-year, and no-year appropriations. 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. Existing Departmental accounting policy requires performing periodic reviews not less frequently than monthly to ensure that ULO balances and disbursements are valid. The current internal control structure is not operating effectively to comply with this policy or to facilitate the accurate reporting of ULO balances recorded in the financial statements. The current process is not systematically and timely identifying open obligations that require deobligation. Additionally, for ULOs identified for closure based on the Department's internal review, bureaus failed to complete deobligation procedures timely or completely and prior to the preparation of financial statements.

The audit process identified adjustments outside of the operation of the internal control structure of approximately $171 million related to ULOs that required deobligation. The Department recorded this audit adjustment in the financial statements.

III. Information Technology

The Department's information technology (IT) internal control structure, both for the general support systems and critical financial reporting applications, did not facilitate a comprehensive risk analysis, effective monitoring of design and performance, and an ability to identify and respond to changing risk profiles. Both the National Institute of Standards and Technology (NIST) and Government Accountability Office (GAO), in its *Federal Information System Controls Audit Manual* (FISCAM), provide control objectives and evaluation techniques. The

Department's IT control structure exhibited design and operation weaknesses that, when combined, are considered to be a significant deficiency, as summarized below.

- The Department could not provide documentation and analysis of automated controls in nine critical financial applications. These automated controls related to data entry validation, management approvals, segregation of duties, and edit controls. Without this information, the Department could not support that data processing objectives regarding data completion, accuracy, and validity were achieved.

- The Department did not map existing IT security policies and procedures to the NIST 800-53 *(Recommended Security Controls for Federal Information Systems)* control families. Without this mapping, the Department could not determine that existing internal control structures, policies, and procedures effectively and adequately mitigated vulnerabilities and were comprehensive.

- The Department could not provide data regarding numerous controls in multiple applications demonstrating the implementation of effective IT control policies and procedures. Without documentation, the Department could not demonstrate that it complied with management's control requirements.

- The Department did not define user roles, responsibilities associated with each role, and/or procedures to assign roles for five key financial applications. The Department also did not compare existing application privileges with users' job responsibilities for two key financial applications. The Department could not demonstrate management's approvals of users' roles in five financial applications. User requests were improperly completed and approved in five applications. Without a comprehensive analysis of roles, the Department could not assess whether transactions were processed in accordance with instructions, and whether adequate segregation of duties was maintained.

- The Department did not maintain adequate segregation of duties in three financial applications. Approximately 50 users had the ability to affect changes to system databases without leaving an audit trail or could perform incompatible functions. Proper access and audit trails help ensure the accuracy, validity, and integrity of data and transactions.

- The Department did not revise system security plans for multiple financial applications. System security plans did not reflect current password practices in three other applications. Accurate and updated system security plans support system certification and internal control effectiveness.

- The Department could not demonstrate that it had a formal, well-documented oversight process to ensure that all systems users successfully completed annual security awareness training. Security awareness and training helps support data integrity and validity.

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The three material weaknesses identified during our audit were not reported by the Department in its FY 2009 FMFIA Assurance Statement. The Department's internal evaluations identified weaknesses in the areas of property and financial reporting. However, the Department did not consider these challenges to be material, and it classified them as significant deficiencies.

This report is intended solely for the information and use of Department management, those charged with governance and others within the Department, and the Inspector General of the U.S. Department of State, OMB, GAO, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

Kearney & Company

December 14, 2009

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND OTHER MATTERS

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

We were engaged to audit the financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2009, and have issued our report dated December 14, 2009. Our report on the consolidated balance sheet of the Department and the related consolidated statement of changes in net position for the year then ended was qualified due to the Department's inability to provide timely and competent evidential material to enable us to perform audit procedures to satisfy ourselves that the property and equipment balance was free of material misstatement. In addition, the report states that because of the matters discussed therein, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the combined statement of budgetary resources for the year ended September 30, 2009. The management of the Department is responsible for complying with laws and regulations applicable to the Department.

As part of obtaining reasonable assurance about whether the Department's 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 Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. As part of our work, we performed tests of compliance with the Federal Financial Management Improvement Act (FFMIA), Section 803(a) requirements. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982. 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 testing disclosed instances of noncompliance or other matters exclusive of FFMIA that are required to be reported under *Government Auditing Standards* and the requirements of OMB Bulletin No. 07-04, and which are summarized in the following paragraphs:

- *Antideficiency Act*. This act prohibits the Department from completing the following: (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 Treasury fund symbols with negative balances potentially in violation of the Antideficiency Act. The Department had previously identified some of the potential violations and was researching others as of the end of our fieldwork.

- *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 in our report on internal controls, we found that the Department does not have effective controls over property, unliquidated obligations, and financial reporting.

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

- *OMB Circular A-127*, *Financial Management Systems.* This circular requires the Department to establish and maintain an accounting system that provides for (1) complete disclosure of the financial results of the activities of the Department; (2) adequate financial information for Department management and for formulation and execution of the budget; and (3) effective control over revenue, expenditure, funds, property, and other assets. However, we found again that the financial system did not maintain effective control over property, unliquidated obligations, and financial reporting.

- *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. We found that the Department's financial system does not provide effective control over personal property, does not manage unliquidated obligations effectively, and is unable to issue year-end financial data in a timely manner.

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 at the transaction level. We noted certain instances, described below, in which the Department's financial management systems did not substantially comply with certain Federal system requirements, Federal accounting standards, and the Standard General Ledger at the transaction level.

Federal Financial Management Systems Requirements:

- A reconciliation of budgetary and proprietary accounts was not part of the Department's routine control structure. A reconciliation as of September 30, 2009, noted differences requiring further research by the Department.
- The Department's core accounting system does not produce complete and timely financial statements. The Department's financial statements are subject to numerous adjustments made outside of the core accounting system. The Department's statement of budgetary resources could not be traced to adequate supporting documentation.
- Certain subsidiary systems, including property systems, are not integrated with the core accounting system. An audit trail from data in the core financial system to detailed source transactions in feeder systems is not always readily available.
- User access and authorization controls were not documented in all cases. Adequate segregation of duties was not maintained in certain financial systems.
- The Department's financial system allows transactions to exceed funds availability at the obligation level in certain instances.

Applicable Federal Accounting Standards:

- We noted certain non-compliances with Federal Accounting Standards in the Department's property accounting practices.
- The audit identified three material weaknesses.

Standard General Ledger at the Transaction Level:

- Financial data could not be appropriately and directly matched to financial statements and OMB and Treasury reports from standard general ledger codes.

Because we could not complete our audit work related to the statement of budgetary resources and property and equipment reported on the balance sheet and statement of changes in net position, we were unable to determine whether there were other instances of noncompliance with laws and regulations related to these areas that are required to be reported.

Kearney & Company

December 14, 2009

United States Department of State

Washington, D.C. 20520

December 15, 2009

UNCLASSIFIED

MEMORANDUM

TO: OIG – Harry W. Geisel

FROM: RM – James L. Millette

SUBJECT: Draft Audit Report on the Department of State's 2009 and 2008 Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the U.S. Department of State's 2009 and 2008 Financial Statements" (Report).

The Department operates in over 260 locations in 172 countries, while conducting business in 150 currencies and an even larger number of languages. Few agencies or corporations have the variety of challenges that the men and women of the Department of State (Department) face daily. Despite these complexities, the Department pursues a commitment to financial integrity, transparency, and accountability that is the equal of any large multi-national corporation. Working closely with the previous Independent Auditor and your office, the Department has a proud tradition of unqualified opinions on our financial statements for the past decade. Therefore, we are disappointed that we were unable to achieve an unqualified opinion on our financial statements.

It has been and continues to be a challenge for the Department to complete the audit and meet OMB's reporting deadline given the complexity of our financial operations. This year's annual audit process was extremely difficult, as we engaged a new audit firm, Kearney & Company (Kearney), to conduct our annual review. Our experience told us that the worldwide operations and complexities of the Department in carrying out the President's foreign policy agenda were going to be a large challenge for a new firm to comprehend in the tight time frame required by the process. Unfortunately, this proved to be true resulting in an outcome that we believe does not truly reflect the full status of the Department's financial program. We will work collaboratively and constructively with Kearney and your office on the issues identified in the Report to implement improvements and ensure their resolution.

The Report on Internal Controls cites three material weaknesses and three significant deficiencies. In regards to the material weaknesses, we agree to the issues identified. However, we disagree with the severity at which they are categorized. With the exception of the IBWC Restatement, the Department reports similar weaknesses in our A-123 Appendix A program but classify them as significant deficiencies versus material weaknesses. While identifying and reporting significant deficiencies of our own, management recognizes the issues identified and reported by the auditors regarding the financial statement restatement, property and equipment, and financial reporting issues, but believes the internal control over these areas provided reasonable (but not absolute) assurance that the objectives of internal control were met during FY 2009.

MATERIAL WEAKNESSES

Environmental Liability Restatement

The Report cites a material weakness that the Department did not have a process in place to analyze and evaluate the International Boundary and Water Commission's (IBWC) financial information prior to its incorporation in the Department's consolidated financial statements. As noted, the Department consolidates financial amounts for the IBWC into our financial statements.

For over a decade, in addition to having their amounts included in our Departmentwide financial statements, IBWC has issued separate audited component financial statements that have received unqualified opinions for a number of years. The audits are conducted by an independent CPA-firm engaged and overseen by the Office of Inspector General (OIG). It is these audited amounts that the Department has incorporated into our financial statements with the environmental liability first recorded in FY 2004. In our Appendix A program, we strive to integrate control related activities within the control framework and leverage the internal reviews already being performed such as the separately audited and issued IBWC financial statements. We saw no reason to question the amounts reported based on the issuance of the unqualified audit opinions on the IBWC financial statements by the OIG and independent auditor.

Further, we believe the accounting treatment and reporting of this item is difficult as to whether the cases involved should follow guidance in SFFAS No. 5, either as Government related events or specifically as contingent liabilities; or as environmental liabilities following guidance in SFFAS No. 6. These cases involve treaty provisions and court orders, decrees, and to quote FASAB "findings that are complex." The Department requested, and the OIG convened, a meeting with the two independent auditors. Unfortunately, no consensus was reached in the meeting. Consequently, the Department submitted a technical inquiry to the Federal Accounting Standards Advisory Board (FASAB) with the understanding that it would follow FASAB's guidance. FASAB's determination was that no accounting liability exists or existed as an immediate result of either case. The Department adopted this guidance and recorded the IBWC restatement accordingly as recommended by our new Independent Auditor.

We appreciate that Kearney concludes that a restatement is an "automatic" material weakness. We understand that the restatement of previously issued financial statements to reflect the correction of a material misstatement is an indicator of a control deficiency that should be regarded as at least a significant deficiency, and a strong indicator of a material weakness in internal control. However, in light of the above, we do not believe that this item represents a material weakness in our current and existing internal control processes. Further, we believe that the determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement. We are unaware of any adverse impact on users of our or the USG financial statements, or on IBWC and Department operations, as a result of the reporting of the environmental liability. The restatements had no effect on the Department's or IBWC's reporting of budgetary resources.

Property and Equipment

Based on the pervasiveness of the deficiencies in internal control identified, and the related risk of a material misstatement in the financial statements, Kearney assessed the Department's property accounting challenges as a material weakness in FY 2009. Kearney elected to combine all of their findings related to property and equipment rather than on an individual basis for real versus personal property. In regards to the material weaknesses, while we agree to the issues identified, we disagree with the severity at which they are categorized.

Land Valuation. The Department's restatement was to correct the valuation of two specific land holdings received from host governments in the mid 1900s. The land acquisitions represented the fair market value of gifts of real property to the Department from other countries. The Department first valued these properties in 1996 at the inception of our accounting for property under the CFO Act. These two properties were part of our valuation of all real property, representing over 3,400 assets. The methodology, developed by a leading CPA firm, and agreed to by the previous Independent Auditor, OIG, OMB and GAO, was to estimate the fair market value of the gifts using reasonable and consistent parameters such as comparable purchases, equivalent square footage, and CPI inflation indices. The methodology erred in that it presented FMV as of 1996 instead of as of the date of the gift. In the intervening 12 years, we are unaware of any adverse impact on users of our financial statements, or on Department operations, as a result of the reporting of the overstated estimated values. The restatements had no effect on the Department's reporting of budgetary resources.

Capital Leases. We agree that we need to expand our processes to analyze property leases, and will work with Kearney to improve these processes.

Completeness and Accuracy of Real Property. The Department agrees that it has not completed a full reconciliation between the Department's real property management system (RPA/BMIS) and the Global Financial Management System's (GFMS) Fixed Assets (FA) module. These two systems serve different and multiple purposes, some of which intersect but many of which do not. Overseas buildings make up the largest balance of overseas real property assets -- totaling $6.4 billion (nearly 73%) net book value (NBV) of the $8.8 billion total NBV for overseas real property (excluding $1.5 billion of construction-in-process) at September 30, 2009. As a result of ongoing discussions on the audit, a reconciliation was completed by the Department between RPA/BMIS and GFMS-FA for all government-owned Chancery and Consulate Buildings. These buildings comprise $5.5 billion (86%) of the total overseas buildings NBV of $6.4 billion. The reconciliation identified a variance of $12.2 million (NBV), a .22% (i.e., less than ¼ of 1%) discrepancy rate. In addition, the Department completed reconciliations on twenty (20) posts. In doing so, the Department identified several other immaterial differences and the need to strengthen the controls and procedures for the accounting for disposals and retirements of buildings. We will take actions to improve these processes and complete the reconciliations over the remaining balances in FY 2010.

Accounting for Personal Property. The Department acknowledges that our internal control structure contains several deficiencies related to the timeliness and accuracy of accounting for personal property. This past year we have continued to improve controls. We established personal property points of contact for each post who work directly with the property accountability officer at post to improve the timeliness of recording acquisitions and disposals. The points of contact also assist the posts with various issues in recording personal property, such as proper fiscal data. The post GSO is now required to provide the ILMS screen print that supports the cost, vehicle receipt and fiscal data accuracy to the FMO as part of the supporting documentation for vehicle payments. The FMO reviews the documentation to ensure accuracy prior to certifying payment. Information regarding all payments for vehicles that have not been entered in ILMS is sent to the posts via the Property Accounting POC. The POC contacts the posts regarding the payment and assists them in data entry of the asset if necessary. Also, the frequency of the review of the asset detail by RM was increased from the prior year. A listing of assets that appeared to be entered improperly, based on various parameters, was sent to Property Accounting for review and post or bureau follow up as necessary. Corrections not processed by year end were captured in the analysis of personal property adjustments completed for yearend reporting. We will continue our efforts in FY 2010 to improve the accounting for personal property.

Accounting for Construction-In-Process (CIP). Kearney selected a statistical sample of current year CIP additions through March 31, 2009 and tested proper capitalization, accuracy of the amounts recorded, and the internal controls surrounding the process. The exceptions identified resulted in a $2.5 million net overstatement of the Department's interim general PP&E balance of approximately $1.5 billion. The Department will work to strengthen controls and oversight to ensure that CIP transactions are recorded accurately in those instances where the benefits of such additional oversight and controls exceed the cost to develop, implement and operate the improvements.

Financial Reporting

As noted by Kearney, the Department compiles its financial statements through a multi-step process using a combination of manual and automated procedures. The existing accounting system does not fully compile the required financial statements for several reasons including the receipt of information to include in the statements from external sources. For example, Kearney reported journal vouchers totaling over $80.4 billion (which treats all debits and credits as absolute amounts) were recorded. Of this amount, about $40 billion (i.e., one-half) is to include financial information received in mid-to-late October (after we have closed for the year) from other agencies that have allocations of the Department's budget authority. There are other similar type activities areas for large portions of the remaining balances where it is more effective to record the amounts to the agencywide financial statement level (e.g., accounts payable accrual estimates) then to attempt to record it to the detailed level that our financial system requires. The same is true for our SF-133 and Statement of Budgetary Resource preparation process. Regardless, the Department agrees that these processes can be improved, and will work with Kearney to do so in FY 2010.

SIGNIFICANT DEFICENCIES

Accounts Payable Accruals

The preparation of financial statements in conformity with GAAP requires the Department to make estimates and assumptions, and exercise judgment that affects the reported amounts of liabilities as of the date of the financial statements. These estimates are based on our best knowledge of historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Due to the size and complexity of many of the Department's programs, the estimates are subject to a wide range of variables, including assumptions on future economic and financial events. Accordingly, actual results could differ from those estimates. The Department believes our estimation process for our domestic accounts payable of about $825 million is reasonably accurate. Our estimation process for our overseas accounts payable of about $140 million could be improved, and we agree that we need to establish a process to record intragovernmental accounts payable. Accordingly, we recorded Kearney's estimated adjustment for intragovernmental accounts payable of $80 million. We appreciate the collaborative and professional manner in which this area of the FY 2009 financial statement audit was conducted, and plan to work closely in FY 2010 with Kearney to improve the accrual process.

Validity and Accuracy of Unliquidated Obligations

The Report cites a significant deficiency for the management of unliquidated obligations. Improvements in the management of undelivered orders will continue to be a priority for the Department in FY 2010. By way of reference, the audit adjustment of $171 million recorded by the Department for FY 2009 is about $27 million less than FY 2008 auditor recommended adjustment, and our total undelivered orders at September 30, 2009 ($13.8 billion) were $1.8 billion greater than the balances at September 30, 2008. Regardless, we agree that further corrective actions are needed and are already underway including the distribution of aging reports, and using recently developed enhancements to our Global Financial Management System capabilities to automate deobligations. In addition, actions to improve contract and grant closeout procedures relative to undelivered orders are being enhanced, and the Senior Assessment Team will be actively engaged with the implementation and oversight of these corrective actions. We appreciate the collaborative and professional manner in which this area of the FY 2009 financial statement audit was conducted, and plan to work closely in FY 2010 with Kearney to improve management of unliquidated obligations.

Information Technology

Kearney reported that the Department's information technology (IT) internal control structure, both for the general support systems and critical financial reporting applications, did not facilitate a comprehensive risk analysis, effective monitoring of design and performance, and an ability to identify and respond to changing risk profiles. While the Department did not completely concur with Kearney's notifications of findings and recommendations, the Department will work to fully understand the weaknesses identified by Kearney and address them in priority order according to the level of risk they present to the Department's operations.

In regards to the report on Compliance and Other Matters, we acknowledge that Kearney concluded that the Department's systems do not substantially comply with Federal financial management systems requirements, Federal accounting standards (GAAP), and the USSGL at the transaction level as of September 30, 2009. While we agree that significant deficiencies exist in certain capabilities within the Department's financial systems, we do not concur with the full extent of the auditor's assessment. We will work with Kearney over the next several months to reconcile our differences of opinion and develop corrective actions to any agreed upon shortcomings.

We thank you for the opportunity to comment on the draft Report. While we may not agree on the severity of issues identified in the Report, we remain fully committed to improving the management of the Department and its financial reporting. To that end, while this year's audit process has been difficult, we would like to extend our appreciation to Kearney & Company for their dedicated efforts on this year's audit.