Management Letter Related to the Audit of the U.S. Department of State 2005 and 2004 Principal Financial Statements

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December 15, 2005

To the Chief Financial Officer
U.S. Department of State:

Under generally accepted auditing standards, auditors are encouraged to report on "significant deficiencies in the design or the operation of the internal control structure that, in the auditor's judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements." In addition, auditors are encouraged to report, in a separate management letter, less material issues.

In performing an audit of the Department's Consolidated Balance Sheets, Consolidating Statements of Net Cost, Consolidated Statements of Changes in Net Position, Combined Statements of Budgetary Resources and Statements of Financing (Principal Financial Statements) as of and for the years ended September 30, 2004 and 2005, we considered the Department's internal control in determining the nature, timing, and extent of the audit tests applied in connection with our audit. Additionally, in accordance with Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended, for those significant internal control policies and procedures that were properly designed and placed in operation, we performed sufficient tests to justify a low assessed level of control risk consistent with *Statement on Auditing Standards* No. 55, promulgated by the American Institute of Certified Public Accountants. Our consideration of internal control did not entail a detailed study and evaluation of any of its elements and was not made for the purpose of making detailed recommendations or evaluating the adequacy of the internal controls to prevent or detect all errors and irregularities.

The Department's management is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures.

The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with the comprehensive basis of accounting described in OMB Bulletin No. A-136, *Financial Reporting Requirements.*

Because of inherent limitations in any internal controls, errors or irregularities may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that it may become inadequate because of changes in conditions or deterioration in operating effectiveness.

Although the purpose of our consideration of internal control was not to provide assurances thereon, matters came to our attention that we want to report to you. These matters are discussed in the attachment. These matters do not affect our report dated December 15, 2005, on the Department's Principal Financial Statements referred to above.

This report is intended solely for the use of the Department's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Very truly yours,

Leonard G. Birnbaum and Company, LLP

Attachment: As stated.

U.S. Department of State
Audit of Principal Financial Statements
September 30, 2004 and 2005

Observations and Conclusions

Prompt Payments

The Department was paying approximately 85 percent of its domestic invoices on time as compared to the government-wide standard of 98 percent. This may, in part, be due to the transition of the disbursing function to the Charleston Financial Service Center. Of greater concern are some of the statistics reported by the Department: 18 percent of invoices had a proper receiving report, 20 percent were paid without three required documents, 95 percent were defective invoices, and 30 percent had proper due date documentation tracking.

We recommend that the Department strengthen its procedures in the disbursements area to address these issues and implement an oversight program to ensure effectiveness of articulated procedures.

Payroll Documentation

Our tests disclosed that the Department did not have all required documentation in all employees' official personnel files, including SF-50s, Federal Employee Health Benefit forms, life insurance election forms for employees electing such coverage, or SF-2817s for employees electing no life insurance. Further, testing of the calculations of employee retirement deductions for Civil Service Retirement System "offset" employees revealed discrepancies higher than 5 percent for two pay periods reviewed.

We recommend that the Department take appropriate steps to ensure that copies of authorizations for all payroll deductions are maintained in personnel files and ensure accurate calculation of employee retirement deductions.

Deferred Maintenance

The Department has not fully complied with the requirements of Statement of Federal Financial Accounting Standard (SFFAS) No. 14 – *Amendments to Deferred Maintenance Reporting* in that the Required Supplementary Information section of the Performance and Accountability Report (1) does not identify each major class of asset for which maintenance has been deferred, (2) does not include a description of the requirements or standards for acceptable operating condition, and (3) does not include deferred maintenance for heritage assets other than real property and furniture and fixtures associated with real property.

We recommend that the Department continue its efforts to comply with the requirements of SFFAS No. 14.

Heritage Property

The Department classified artwork that was not framed or was undergoing preservation treatment as "inactive." Accordingly, the artwork count was reduced by items deemed to be inactive. We believe the Department should include all artwork in the count of heritage assets unless the artwork is formally removed, missing, or damaged beyond repair.

We recommend that the Department include all artwork, including "inactive" property, in its count of heritage assets.

Lack of Overseas Accounts Payable Subsidiary Record

The Department does not maintain an overseas accounts payable subsidiary record. Rather, the amounts appearing in the general ledger accounts, and ultimately the financial statements, represent the results of all transactions (posting of payables, liquidations, and adjusting entries) on a rolling database basis.

During FY 2004, the Department began the process of implementing an accounts payable subsidiary ledger that currently supports domestic accounts payable.

We recommend that the Department continue with its efforts to establish an overseas accounts payable subsidiary ledger.

Accounts Receivable – General

Our review of accounts receivable disclosed that the amounts presented on the balance sheet included amounts from fund 3200, which is reserved as the repository for accounts receivable related to expired funds. Such receivables, if deemed collectible, are properly reported by the Department of the Treasury.

7. Unreconciled Differences in Fund Balance With Treasury

The absolute value amount of the unreconciled difference between the adjusted Treasury balance and the adjusted Central Financial Management System (CFMS) balance increased during FY 2005. As of September 30, 2005, the amount of this difference was approximately $74 million.

We recommend that the Department continue its efforts to reduce unreconciled differences between the adjusted Treasury balance and the adjusted CFMS balance.

8. Payroll Accrual

The amounts accrued for payroll as of September 30, 2005 and 2004, were significantly less than appropriate.

We recommend that the Department reexamine its process for accruing payroll to enhance the accuracy of payroll accruals.

9. Time and Attendance Controls at Embassy Berlin

Our review of time and attendance controls at Embassy Berlin disclosed that timekeepers were entering their own time and attendance data into the Windows based T&A system. This created an opportunity for entering false or incorrect data into the system.

We recommend that the Department implement procedures to ensure that timekeepers' time and attendance data are entered into the Windows based T&A system by someone other than the timekeepers themselves.

10. Anti-Deficiency Act

During FY 2005, no formalized process had been put in place for the oversight of potential violations of the Anti-Deficiency Act. The Bureau of Resource Management has developed objectives for an Anti-Deficiency Act monitoring program and discussed in a cursory fashion the process with the legal adviser assigned to review and issue opinions on financial issues. The legal adviser has agreed to review the process in FY 2006.

11. <u>Response to Management Letter</u>

Although the management letter related to the audit of the Department's 2004 financial statements was issued on March 8, 2005, the Department did not respond to the letter until November 13, 2005.

We recommend that the Department implement procedures to ensure a more timely response to management letters.