

**International Cooperative
Administrative Support Services'
Financial Statements**

Independent Auditor's Report

September 30, 2005 and 2004

AUD/FM-07-18, February 2007

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INDEPENDENT AUDITOR'S REPORT

To the ICASS Executive Board:

We have audited the Statements of Financial Position, Statements of Operations and Changes in Net Position, and Statements of Cash Flow (Financial Statements) as of and for the years ended September 30, 2005 and 2004, for the International Cooperative Administrative Support Services (ICASS) program.

In our opinion, the 2005 and 2004 ICASS Financial Statements are presented fairly, in all material respects.

We found:

- reportable conditions on weaknesses in internal controls, and
- instances of noncompliance with selected provisions of applicable laws and regulations tested.

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

FINANCIAL STATEMENTS

In our opinion, ICASS' 2005 and 2004 Financial Statements, including the notes thereto, present fairly, in all material respects, ICASS' financial position as of September 30, 2005 and 2004, and the net cost of operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

INTERNAL CONTROL

We considered ICASS' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the Financial Statements. We limited our internal control testing to those controls necessary to achieve the objectives described in the Office of Management and Budget's (OMB) Bulletin 01-02, *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 express 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 any other laws and regulations that OMB, ICASS management, or the Inspector General has identified as being significant and for which compliance can be objectively measured and evaluated; and
- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in 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 ICASS' 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 that 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 noted the following two matters that we consider to be material weaknesses as defined above.

- We have identified significant weaknesses related to the recording of personal property and related depreciation expense and accumulated depreciation. The Department of State (Department), which manages ICASS' property, does not have a system of controls to identify and record property in the hands of contractors. Further, the Department's controls over aircraft, 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 of the reasons why; (3) property not reported by posts and bureaus; (4) significant unreported vehicle armoring costs; and (5) errors in depreciation resulting from incorrect inservice dates.
- We have identified weaknesses related to the Department's 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 that process data using these networks, including financial management systems such as those used to process ICASS' transactions, may also be vulnerable. These deficiencies were cited as material weaknesses in our audit of the Department's 1997 Principal Financial Statements and subsequent audits through 2002. In response, the Department initiated a program to assess its information systems security on a comprehensive and continuing basis. As a result, we downgraded these deficiencies to a reportable condition in connection with our audit of the Department's 2003 Principal Financial Statements. Our review of information system security in connection with our audit of the Department's 2005 Principal Financial Statements disclosed that the Department was no longer assessing information system security to the same extent as it was during 2003 and 2004. Accordingly, we have reclassified this deficiency to a material weakness.

We noted the following matter involving internal control that we consider to be a reportable condition.

- The Department's financial and accounting system, which is used to process ICASS transactions, as of September 30, 2005, was inadequate. There is a risk of materially misstating financial information under the current conditions. The principal area of inadequacy related to ICASS was that certain elements of the financial statements, including, but not limited to, personal property 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 financial statements increases the potential for omission of significant transactions.

The above reportable condition was cited in our audit of ICASS' 1997 Financial Statements and subsequent audits.

These deficiencies in internal control may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiency. Unaudited financial information reported by ICASS, including budget information, also may contain misstatements resulting from these deficiencies.

We noted certain other matters of less significance involving internal control that we have reported to ICASS management in a separate letter dated March 30, 2006.

COMPLIANCE WITH LAWS AND REGULATIONS

ICASS' management is responsible for complying with laws and regulations applicable to ICASS. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of ICASS' 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 01-02. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to ICASS. The objective of our audit of ICASS' 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 in the preceding paragraph did not disclose instances of noncompliance with the laws and regulations that are required to be reported under the Comptroller General's *Government Auditing Standards* and OMB Bulletin 01-02. However, ICASS' Financial Statements were prepared from the books and records of the Department, as ICASS is a separate accounting activity within the Department's Working Capital Fund. The Department's financial management system does not comply with the following.

- Budget and Accounting Procedures Act of 1950. This 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 does not provide effective control over personal property.
- 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 activities; (2) adequate financial information for 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 systems did not maintain effective control over personal property.

The above areas of noncompliance were cited in our audit of ICASS' 1997 Financial Statements and subsequent audits.

The Chief Financial Officers Act, as amended, requires agencies to develop and maintain a financial management system, including financial reporting and internal controls, that complies with applicable accounting principles, standards, and requirements. However, ICASS' financial management system did not comply with Statement of Federal Financial Accounting Standard Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government* (SFFAS 4). Paragraph 108 of SFFAS 4 states that if an entity provides goods or services to another entity, regardless of whether full reimbursement is received, the providing entity should continue to recognize in its

accounting records, the full cost of those goods or services. ICASS' costing structure, which is the basis for invoices to customer agencies, limits personnel costs to personnel who are designated as ICASS personnel and whose duties and functions are limited to ICASS activities. There is no provision in ICASS' costing structure for recognition of supervisory or administrative support of these personnel.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance.

RESPONSIBILITIES AND METHODOLOGY

ICASS management has the responsibility for:

- preparing the 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; and
- complying with applicable laws and regulations.

Our responsibility is to express an opinion on the Financial Statements based on our audit. Auditing standards generally accepted in the United States of America require that we plan and perform the audit to obtain reasonable assurance about whether the Financial Statements are free of material misrepresentation and presented fairly in accordance with accounting principles generally accepted in the United States of America. We considered ICASS' internal control for the purpose of expressing our opinion on the ICASS Financial Statements referred to above and not for providing an opinion on 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:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;

- obtained an understanding of the internal control relevant to financial reporting by obtaining an understanding of ICASS' internal controls, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls;
- obtained an understanding of internal control over performance measures included in Management's Discussion and Analysis, including obtaining an understanding of the design of internal controls relating to the existence and completeness assertions, and determined whether they had been placed in operation;
- tested compliance with selected provisions of laws and regulations that may have a direct and material effect on the financial statements;
- obtained written representation from management; and
- performed other procedures as we considered necessary in the circumstances.

Our audits were conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards (2003 Revision)*, issued by the Comptroller General of the United States. We believe that our audits provide a reasonable basis for our opinion.

The Management's Discussion and Analysis, Required Supplementary Information, and Additional Supplementary Financial and Management Information are not required parts of the Financial Statements but are supplementary information required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. We have applied 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 and ICASS management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

A handwritten signature in cursive script, appearing to read "Leonard G. Birnbaum", followed by the letters "LLP" written in a slightly larger, more distinct hand.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
March 30, 2006

Appendix



United States Department of State

Washington, D.C. 20520

JAN 24 2007

MEMORANDUM

TO: OIG – Mr. Howard J. Krongard

FROM: RM/EX – Philip J. Schlatter *PJS 24 Jan 2007*

SUBJECT: Draft Audit Report on the International Cooperative
Administrative Support Services' 2005 and 2004 Financial
Statements

Thank you for the opportunity to review and comment on the subject draft report. In relation to internal control, the report identified two material weaknesses: (1) the vulnerability of our information systems networks to unauthorized access, and (2) deficiencies related to the recording of personal property and related depreciation expense and accumulated depreciation. The report also identified the inadequacy of the Department's financial management system to routinely issue timely financial statements as a reportable condition.

We are pleased to report that during 2006 we continued to make progress to strengthen our controls in the systems and processes used to prepare financial statements. For example, the Department's security for information systems and processes to account for personal property were strengthened. As a result, the Independent Auditor has downgraded these areas to reportable conditions (from material weaknesses) in their report on the Department's FY 2006 agencywide financial statements. We also recognize that our commitment and efforts must remain strong in 2007 and beyond to resolve all remaining deficiencies in these areas.

Our comments on the issues described above are contained in our responses to the audit reports relating to the FY 2004 and 2003 Department-wide Principal Financial Statements included in our Performance and Accountability Reports for those years.

We wish to thank your staff, and the staff of Leonard G. Birnbaum and Company, for the cooperative and professional manner in which the audit was conducted. If you have any questions concerning our response to the audit report, please contact Chris Flagg, Deputy Chief Financial Officer, on 202-261-8620.

CC: Leonard G. Birnbaum - Leslie Leiper
RM/GFS - James L. Millette
RM/ICASS - Ismail Asmal
RM/BP - Jim Tychoski
RM/EX - Phil Schlatter, Acting