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**INTERNATIONAL COOPERATIVE
ADMINISTRATIVE
SUPPORT SERVICES FINANCIAL STATEMENTS**

INDEPENDENT AUDITOR'S REPORT

September 30, 2003 and 2002

Report No. AUD/FM-05-38

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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 Flows (financial statements) as of and for the years ended September 30, 2003 and 2002, for the International Cooperative Administrative Support Services (ICASS) program and have examined internal control over financial reporting in place as of September 30, 2003. We have also examined compliance with laws and regulations.

In our opinion, the 2003 and 2002 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.

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

ICASS FINANCIAL STATEMENTS

In our opinion, the 2003 and 2002 ICASS financial statements, including the notes thereto, present fairly, in all material respects, the financial position of ICASS as of and for the years ended September 30, 2003 and 2002, the results of operations, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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INTERNAL CONTROL

We considered ICASS's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and 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:

- 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 Office of Management and Budget (OMB), ICASS management, or the Inspector General of the Department of State have 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's ability to record, process, summarize, and report financial data consistent with the assertions of management in the ICASS financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the specific 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 or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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We noted two matters, discussed in the following paragraphs, involving internal control that we consider to be reportable conditions.

- We have identified weaknesses 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, which process data using these networks, may also be vulnerable. The Department has initiated a program to assess its information systems security on a comprehensive basis.
- The Department's financial and accounting system, as of September 30, 2003, was inadequate. This inadequacy prevented ICASS from routinely issuing timely financial statements. The risk of materially misstating financial information is high under the current conditions. The principal area of inadequacy was that certain elements of ICASS's financial statements, including, but not limited to, personal property, capital leases, and certain accounts payable, are developed from sources other than the general ledger. This is due, at least in part, to untimely processing and reporting of transactions by posts. OMB Circular A-127, Financial Management Systems, requires that transaction processing be applied consistently throughout the Department's financial management system. The use of sources other than the general ledger to generate elements of the financial statements increases the potential for omission of significant transactions.

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

The 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 deficiencies. Unaudited financial information reported by the Department, 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, 2005.

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 ICASS financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the

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determination of financial statement amounts and certain other laws and regulations. However, the objective of our audit of the 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, contained 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 referred to above 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 any material instances of noncompliance with the laws and regulations that are required to be reported under the Comptroller General's *Government Auditing Standards*, specifically with respect to ICASS financial statements. However, the 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, and inadequacies of the Department's financial management systems are a failure to 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 financial systems: (1) did not manage undelivered orders effectively; and (2) did not issue interim financial statements that are necessary for effective management operations.
- Federal Managers Financial Integrity Act (FMFIA) of 1982 – This 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 financial system did not manage undelivered orders effectively. Hence, these funds are not adequately protected from waste or loss.
- Chief Financial Officers Act of 1990 – This requires the development and maintenance of an integrated accounting and financial management system that: (1) complies with applicable accounting principles, standards and requirements, and

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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 financial systems: (1) did not issue interim financial statements, which are necessary for effective management; and (2) did not provide complete information in that certain elements of the financial statements are developed from sources other than the general ledger.

- 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 systems did not maintain effective control over undelivered orders.

The above areas of noncompliance were cited in our audit of ICASS'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. We noted certain other instances of noncompliance that we have reported to ICASS management in a separate letter dated March 30, 2005.

RESPONSIBILITIES AND METHODOLOGY

ICASS management has the responsibility for:

- preparing the ICASS Financial statements 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.

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Our responsibility is to express an opinion on the ICASS 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 ICASS financial statements are free of material misrepresentation and are presented fairly in accordance with accounting principles generally accepted in the United States of America. We considered the Department's 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 and certain other laws and regulations.

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 over financial reporting, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls;
- tested compliance with selected provisions of laws and regulations that may materially affect the financial statements;
- obtained written representations 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*, issued by the Comptroller General of the United States. We believe that our audits provide a reasonable basis for our opinion.

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This report is intended for the information of the Inspector General of the 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.

The Department agreed with the findings in this report, and its comments on the draft are included in their entirety as Appendix A.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
March 30, 2005

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Appendix A



United States Department of State

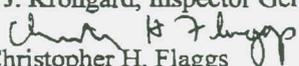
Deputy Chief Financial Officer

Washington, D.C. 20520

AUG 1 - 2005

MEMORANDUM

TO: OIG – Howard J. Krongard, Inspector General

FROM: RM/DCFO – Christopher H. Flaggs 

SUBJECT: Draft Audit Report on the International Cooperative Administrative Support Services' (ICASS) 2003 and 2002 Financial Statements and Management Letter

Thank you for the opportunity to review and comment on the subject draft report. In relation to internal control, the report identifies two reportable conditions: (1) weaknesses in information system security that could be exploited to have a detrimental effect on the information used to prepare ICASS' financial statements, and (2) the inadequacy of the Department's financial and accounting system, since the financial statements for the ICASS Program are prepared using the Department's system.

We are pleased to report that significant progress has been made since 2002 to strengthen our controls in each of the areas identified above. For example, the Department's work towards improving information systems security was considered sufficiently advanced by the end of FY 2003 to allow the auditor to reduce this previously reported material weakness to a reportable condition. Our comments on the issues described above are contained in our responses to the draft audit reports relating to the FY 2003 and 2004 Department-wide Principal Financial Statements included in our Performance and Accountability Reports for those years.

We wish to thank your staff for the cooperative manner in which the audit was conducted. If you have any questions concerning our response to the audit report, please contact Sheila Conley, Managing Director, Financial Policy, Reporting and Analysis Directorate, on 202-663-1447.

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CC: RM - Sid L. Kaplan, Acting
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RM/GFS - James L. Millette
RM/ICASS - Ismail Asmal
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