United States Department of State
and the Broadcasting Board of Governors

Office of Inspector General

AUG 25 2010

MEMORANDUM

TO: RM – Mr. James L. Millette, Acting

FROM: OIG/DIG – Harold W. Geisel

SUBJECT: Report on the *Audit of Department of State Corrective Action Plans for Financial Reporting* (AUD/FM-10-27)

The subject report, prepared by Kearney & Company, P.C., an independent external auditor, is attached for your review and action. As the action office for Recommendations 1 through 6, please provide your response to the report and information on actions taken or planned for the six recommendations within 30 days of the date of this memorandum. Actions taken or planned are subject to follow-up and reporting in accordance with the attached compliance response information.

Kearney & Company incorporated your comments as appropriate within the body of the report and included them in their entirety as Appendix B.

OIG appreciates the cooperation and assistance provided by your staff during this audit. If you have any questions, please contact Evelyn R. Klemstine, Assistant Inspector General for Audits, at (202) 663-0372 or Gayle Voshell, Division Director, at (703) 284-2681 or by e-mail at voshellg@state.gov.

Attachments: As stated.

cc: RM/DCFO – Chris Flaggs
RM/EX – Philip J. Schlatter, Acting
Kearney & Company, P.C. – David Zavada

U.S. Department of State

Audit of Corrective Action Plans for Financial Reporting

AUD/FM-10-27

August 2010

KEARNEY & COMPANY *Certified Public Accountants and Consultants*

Point of Contact:
David Zavada, Partner
1701 Duke Street, Suite 500
Alexandria, VA 22314
703-931-5600, 703-931-3655 (fax)
dzavada@kearneyco.com
Kearney & Company's TIN is 54-1603527, DUNS is 18-657-6310, Cage Code is 1SJ14
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KEARNEY& COMPANY

1701 Duke Street, Suite 500, Alexandria, VA 22314
PH: 703.931.5600, FX: 703.931.3655, www.kearneyco.com

June 1, 2010

Mr. Harold W. Geisel, Deputy Inspector General
U.S. Department of State
Office of the Inspector General
2201 C Street, N.W.
Washington, DC 20520

Kearney & Company, P.C., is pleased to submit this performance audit report related to the Department of State's (Department) corrective action plans developed to address financial reporting material weaknesses as reported in the Department's Independent Auditor's Report in the FY 2009 *Agency Financial Report*. This performance audit is one of three performance audits that the Department's Office of Inspector General has engaged us to perform related to corrective action plans to address material internal control weaknesses. This performance audit was designed to meet the objectives identified in Appendix A, "Objectives, Scope, and Methodology," of this report.

We conducted this performance audit from February 24 through June 1, 2010, in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. The purpose of this report is to communicate the results of our performance audit and the related findings and recommendations.

We would like to thank the Department bureaus and offices involved for their cooperation during the course of this engagement.

Kearney & Company

Kearney & Company, P.C.

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EXECUTIVE SUMMARY

At the request of the Office of Inspector General (OIG), Kearney & Company, P.C. (referred to as "we" or "our" in this report), audited the Department of State's (Department) corrective action plans (CAP) developed to address internal control deficiencies identified during the course of the FY 2009 financial statement audit in the area of financial reporting. Management is responsible for establishing, maintaining, and assessing internal control. Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, states: "Effective internal control is a key factor in achieving agency missions and program results through improved accountability. Identifying internal control weaknesses and taking related corrective actions are critically important to creating and maintaining a strong internal control infrastructure that supports the achievement of agency objectives."

We performed this audit in order to assess the Department's efforts in developing CAPs that would effectively address internal control deficiencies. During this audit, we performed additional analyses to identify underlying causes of the financial reporting deficiencies reported during our FY 2009 financial statement audit. We also reviewed the two draft CAPs provided by Department management for financial reporting, one related to proprietary financial reporting[1] and the other related to budgetary financial reporting. In addition, we conducted follow-up interviews with key Department personnel involved in the financial reporting process. Our analyses focused on the year-end journal voucher (JV) and budgetary adjustment processes. We assessed the quality of the Department's draft CAPs using criteria adapted from best practices for well-developed CAPs and OMB guidance, all of which were accepted by OIG.

The Department had developed five planned actions for the proprietary financial reporting CAP and seven planned actions for the budgetary financial reporting CAP. The CAPs were focused on critical functional areas, but they did not identify the root causes of the deficiencies or include specific planned actions or events for addressing root causes.

Both CAPs indicated that the Department planned to perform an additional analysis of critical functional areas essential to improving financial reporting within the Department. The CAPs identified key areas to review during this analysis. This additional assessment could serve as a basis for a formal root cause analysis and could lead to the subsequent development of specific planned actions and events to address the underlying causes of internal control deficiencies.

In addition to recommending that the Department perform a formal root cause analysis, we also identified other opportunities for the Department to improve the quality and effectiveness of the CAP in the following areas:

- Perform a formal level-of-effort analysis to assign resource levels to planned actions.
- Assign accountability at a lower level and utilize the OMB Circular A-123, Appendix A, governance structure to monitor accountability for corrective actions.
- Include measurable milestones and critical tracking metrics in the CAP.

[1] Proprietary accounts, in contrast to budgetary accounts, show the actual financial position of an organization, such as actual assets or liabilities.

- Leverage the OMB Circular A-123 assessment and testing process to validate the effectiveness of the outcomes of corrective actions.

Our recommendations are intended to improve the quality of the CAPs and the likelihood that effective corrective actions will be implemented.

MANAGEMENT COMMENTS AND AUDITOR REPLY

The Bureau of Resource Management (RM) stated that it will continue to enhance the CAPs by incorporating the report's recommendations as well as improvements that RM identifies through its ongoing efforts. RM's response to the draft report is included in Appendix B.

RM noted in its response that we had not found any "significant elements missing" in the CAPs that would prevent the Department from addressing material weaknesses identified during the FY 2009 financial statement audit. However, in regard to the CAPs for financial reporting, we found that critical management analysis was still underway and that the CAPs did not include specific planned actions or events to address the root causes of financial reporting deficiencies, including those related to the Statement of Budgetary Resources (SBR). Our report noted that the management analysis underway could serve as the basis for a formal root cause analysis and the development of specific planned actions to address the underlying causes of internal control deficiencies. Management may also develop additional compensating controls to mitigate the material weakness over financial reporting prior to addressing all root causes.

BACKGROUND

Executive Branch agencies, including the Department, must prepare and submit audited financial statements to OMB. The Balance Sheet and Statement of Net Cost (SNC) include proprietary information. Specifically, the Balance Sheet presents amounts of assets owned or managed by the Department, amounts owed, and the net position of the Department. The SNC shows the net cost of operations for the Department, as a whole, by major program. For FY 2009, the Department reported a total net position of approximately $37 billion and a total net cost of approximately $22 billion.

The SBR and related disclosures provide information about how budgetary resources were made available to the Department, as well as the status of the budgetary resources at the end of the reporting period. The SBR is the only financial statement predominantly derived from an entity's budgetary general ledger in accordance with budgetary accounting rules. Information on the SBR should be reconcilable to the budget execution information reported on Standard Form (SF) 133, Report on Budget Execution and Budgetary Resources, and with information reported in the Budget of the United States Government to ensure the integrity of the numbers presented. In its FY 2009 financial statements, the Department reported total budgetary resources of approximately $50 billion.

FINANCIAL STATEMENT AUDIT DEFICIENCIES RELATED TO FINANCIAL REPORTING

For FY 2009, we reported the Department's financial reporting process as a material weakness.[2] Specifically, we noted that the Department did not have adequate systems, processes, or controls in place to support the completion of a financial statement audit to meet OMB deadlines. We also found that the Department had a non-automated, manually intensive financial statement process and lacked support for journal entries generated by that manual process. In addition, key year-end financial reporting deadlines were not met for the production of draft financial statements, supporting JVs, trial balances, and crosswalks. The Department issued multiple versions of the draft financial statements within 4 days, and the final SBR and supporting details were submitted 11 days late during a 30-day extension period. Accordingly, this led to delays in conducting audit procedures and, ultimately, the inability to render an opinion on the SBR.

We also reported that 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 is sometimes manually keyed into crosswalk templates (Excel spreadsheets), which ultimately populate the financial statements. To prepare the balance sheet and the consolidated statements of net cost and net position, over 100 manual JVs 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 SNC and SBR, resulted in further delays in the production of final financial statements because of 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 a manual, labor-intensive process to develop the SBR. During the compilation process, multiple manual adjustments were required to be posted. A total of 2,602 manual adjustments, with a net value of negative $1.4 billion and an absolute value of $202.4 billion, were required to reconcile the SBR with the SFs 133. Despite these adjustments, $28.2 million (absolute value) of differences remained between the SBR and the SFs 133.

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.

[2] *Independent Auditor's Report on the Department of State 2009 and 2008 Financial Statements* (AUD/FM-10-03, Dec. 2009).

SCOPE AND METHODOLOGY

Correcting the deficiencies related to financial reporting in an organization as broad in scope and as complex as the Department requires a well-developed CAP. Well-developed CAPs include the following components:

- Identification of root causes
- Planned actions/events
- Level-of-effort analysis
- Responsibility and accountability
- Milestones and tracking status
- Performance metrics and validation

In conducting our audit of the Department's CAPs related to financial reporting, we used these components of a well-developed CAP as criteria. Each of these items is discussed in greater detail in Appendix A, which provides additional information on the scope and methodology of the audit.

Our audit entailed performing additional analyses of the FY 2009 internal control deficiencies to identify underlying causes. We then assessed the quality of the Department's CAPs using the criteria described for well-developed CAPs.

ROOT CAUSE ANALYSIS

Identifying root causes is a critical first step in establishing well-developed CAPs. A comprehensive root cause analysis helps to ensure that planned actions fully address root causes rather than symptoms of internal control deficiencies. This effort involves considerable discovery and engagement of all process owners and offices involved with the financial reporting process. The Department has developed internal guidance for conducting and documenting a root cause analysis. Using this internal guidance would result in a root cause worksheet and other supporting documents to enable the responsible office to establish an action plan to address and permanently eliminate the deficiency.

The Department has prepared two CAPs related to financial reporting, one related to proprietary financial reporting and the other related to budgetary financial reporting. The Department's CAPs identify critical functional areas where an additional analysis will be performed. This additional analysis could serve as a basis for a formal root cause analysis and the subsequent development of specific planned actions and events to address the underlying causes. According to the proprietary financial reporting CAP, the Department plans to perform an additional analysis of the following areas:

1. <u>Analyze Parent/Child Reporting</u> – Review and refine processes used to receive, analyze, post, and report child allocation information. Renew memorandum of understanding for FY 2010, where applicable, with revised dates to meet accelerated reporting requirements.

2. Analyze Year-End Roll-Forward Schedule – Review FY 2009 requests and submissions to identify improvements and plans to meet anticipated requested dates and deliverables for FY 2010.

3. Identify New Reporting Changes for FY 2010 – Identify any new reporting changes for FY 2010 and ensure procedures and processes are in place to report in a timely and accurate manner.

4. Analyze Fifth Quarter[3] FY 2009 Hyperion JVs – Perform complete analysis of Hyperion fifth quarter FY 2009 JVs with the objective of identifying those JVs that should have been processed within the Global Financial Management System (GFMS), those that could potentially be processed in GFMS if current processes and procedures are modified, and those that must be processed in Hyperion but could be executed earlier if current processes and procedures are modified.

5. Analyze Multiple Versions of Statements at the End of the FY 2009 Reporting Period – Review events that caused changes to the financial statements and implement changes to address.

According to the budgetary financial reporting CAP, the Department plans to perform additional analyses in the following areas:

1. Analyze Parent/Child Reporting – Review and refine processes used to receive, analyze, post, and report child allocation information. Renew memoranda of understanding for FY 2010, where applicable, with revised dates to meet accelerated reporting requirements.

2. Analyze Year-End Roll-Forward Schedule – Review FY 2009 requests and submissions related to the SBR to identify improvements and plans to meet anticipated requested dates and deliverables for FY 2010.

3. Identify New Reporting Changes for FY 2010 – Identify any new reporting changes for FY 2010 and ensure procedures and processes are in place to report in a timely and accurate manner.

4. Analyze SBR Preparation Process – Perform analysis of SBR compilation process with the objective of evaluating the processes used to compile the SBR and establish a plan of action for ensuring the processes are appropriate and efficient.

5. Analyze 5th Quarter FY 2009 Hyperion JVs – Use analysis of fifth quarter Hyperion JVs to identify those items that will continue to be Hyperion adjustments and will need to be incorporated into the SFs 133.

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[3] The fifth quarter designates the period after the end of the fiscal year but before the financial statements are issued. During that period, adjustments are made as needed.

6. Analyze Adjustments, Documentation, and Processes Made During SF 133 Adjustment Window – Analyze adjustments, review events and causes for adjustments, and implement changes to eliminate need for adjustment window.

7. Analyze SF 133 Preparation Process – Perform an analysis of the SF 133 preparation process with the objective of evaluating the processes used to prepare the SFs 133 and establish a plan of action for ensuring these processes are appropriate and efficient.

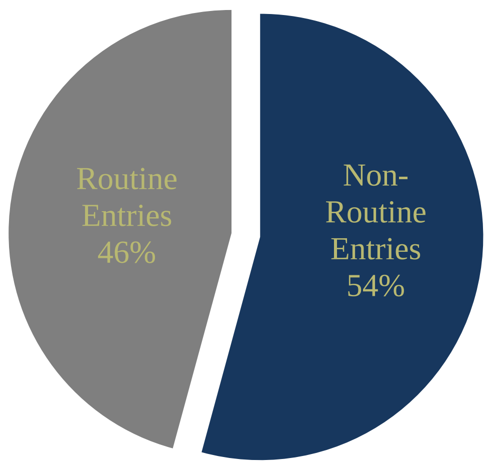
Based on our analyses of the deficiencies identified and reported during our FY 2009 financial statement audit, we identified some underlying causes of the financial reporting internal control deficiencies. We specifically focused on year-end JVs and other budgetary adjustments made on SF 133 worksheets supporting the SBR. Not all of these issues were addressed in the Department's financial reporting CAPs. Our list of underlying causes should not be interpreted as a comprehensive list of all root causes, as additional causes may have been identified had additional entries or processes been reviewed. Also, additional causes may be identified under a more in-depth formal analysis performed by management.

1. Non-Routine Correcting Entries Comprise 54 Percent of Year-End JV Adjustments

The Department records proprietary JVs to Hyperion, the Department's financial reporting system. We determined whether the year-end Hyperion JVs were routine or non-routine entries. In many cases, a single JV number was used to compile many entries covering a myriad of purposes. We reviewed each of these purposes separately and counted them each as an individual entry.

We found that 177 Hyperion entries were processed at yearend, between the close of GFMS and the submission of the Agency Financial Report (AFR) to OMB. Of these 177 entries, 96 were considered to be non-routine JVs that corrected an accounting error or recorded activity that was not otherwise accounted for through routine transaction processing. As shown in Figure 1, non-routine entries accounted for 54 percent of the total number of Hyperion JV entries.

Figure 1: Routine and Non-Routine Entries as a Percentage of Total Entries



Source: Kearney prepared based on analysis of Hyperion JV entries.

We analyzed each non-routine entry to determine the reason for the adjustment. We noted that many of the non-routine entries were the result of preventable errors as follows:

- Seventeen entries corrected items that had been incorrectly posted originally.
- Twelve entries corrected invalid activity within a fund or general ledger account.
- Eleven entries corrected beginning and ending balances.
- Ten entries corrected transactions that were never posted.
- Nine entries corrected items that had been originally miscalculated.
- Nine entries corrected erroneous entries made using another JV.
- Eight entries deleted duplicate entries.
- Six entries were to make adjustments to Fund Balance with Treasury.
- Five entries were additions and deletions to property.
- Three entries corrected items that had been entered using improper methodology.
- Two entries corrected system errors.
- Four entries were for miscellaneous purposes.

During our review of the Hyperion JVs, we noted that supporting documentation was inconsistent. Some entries had minimal accompanying information. The Department does not have policies that require staff to include adequate documentation and support with each JV entry.

The high volume of correcting entries during the year-end reporting period caused the Department to have significant delays in producing its final financial statements and AFR. The amount of time staff spent creating and entering non-routine correcting JVs rather than focusing efforts on processes that add value significantly hindered the Department's ability to produce timely financial statements. In addition, the Department's current process of recognizing additions and disposals of property (including gains and losses from the disposals) after the end of the year indicates that the Department lacks timely and complete documentation related to its assets.

Root Causes

- ***Lack of appropriate accounting policies and procedures.***
  The Department had not developed accounting policies and procedures for requiring consistent and complete supporting documentation for JVs. The Department's policies do not include a description of effective controls and procedures. This caused inconsistencies in recognizing, recording, and documenting accounting events and in adequately reporting them in the Department's financial statements and AFR. Some of the JV entries that we reviewed included little or no documentation and analysis to support the purpose of the entry.

- ***Inadequate review of accounting entries.***
  The Department does not adequately review accounting transactions to ensure that proper entries are made to reflect accounting events. As indicated in Figure 1, about 54 percent of the Hyperion transactions were made to correct erroneous entries processed during the initial recording of an accounting event. If the transactions had been entered correctly initially, a significant amount of time would have been saved and the Department's ability to prepare timely financial statements would have improved.

- ***Insufficient management review of JV entries.***
  We found that management did not perform sufficient detailed reviews of the JVs to ensure that the methodologies used to prepare the adjustments were valid, which led to additional corrective entries. If management had conducted a detailed review of initial JV entries, fewer corrective entries would be needed. Additional review of the JV entries could decrease the chance for errors.

- ***Lack of periodic account analysis.***

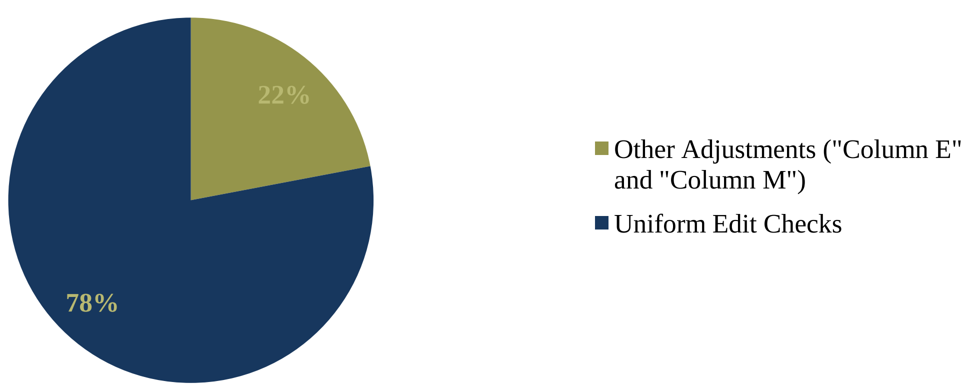
  The Department does not have a process in place to ensure that effective fund reconciliations are performed at the transaction level in a timely manner. At the end of FY 2009, the Department processed numerous JV entries designed to correct invalid entries or mistakes in posting to fund symbols for fund activities processed during the fiscal year. These adjustments could have been entered properly or corrected at a transaction level earlier in the year if they had been identified in a timely manner. However, because they were not identified until after the end of the fiscal year, they were instead adjusted and processed using JVs at yearend, and they did not include transaction-level detailed information.

2. Uniform Budgetary Adjustment Methodologies Were Not Adequately Supported

The Department records budgetary adjustments directly to the SF 133 Crosswalk Adjustment Worksheets (SF 133 Worksheets), which are spreadsheets maintained outside of the Hyperion JV process. The SF 133 Worksheets are the basis for the individual SF 133 Report on Budget Execution submitted to the Department of the Treasury and OMB, as well as the SBR included in the Department's AFR. We analyzed the SF 133 Worksheets prepared by the Department during FY 2009. We also obtained an explanation from the Department on the methodology used to adjust the SF 133 Worksheets, including the edit checks used to determine which fund symbols require adjustment. Edit checks are used by fund managers to ensure that fund symbols are in balance and that adjustments are properly made. Fund managers can then identify additional adjustments.

The Department has a uniform methodology for making many adjustments to the SF 133 Worksheets. The appropriate fund manager ensures the SF 133 Worksheets pass all edit checks before the SF 133 is submitted. As long as the totals on the Worksheets pass all the edit checks, no additional support for adjustments is required to accompany the SF 133 Worksheets. The Department was unable to provide documentation to support the propriety of these adjustments. These unsupported uniform adjustments accounted for 78 percent of all adjustments made to the SF 133 Worksheets (see Figure 2).

Figure 2: Composition of Budgetary Adjustments Made to SF-133 Worksheets



Source: Kearney prepared based on review of budgetary adjustments.

For the adjustments made during the uniform edit checks, the fund managers were resolving abnormal conditions identified during the SF 133 Worksheets edit check process or during a comparison of data to information provided by the Treasury. However, the fund managers did not obtain information regarding the cause of the difference. In addition, the fund managers made these adjustments at the fund symbol level but not at the transaction level. In addition, we found that the adjustments were not sufficiently reviewed to ensure that they were appropriate.

We also noted that some adjustments were made to align budgetary and proprietary accounts with each other. The Department does not have a process in place to routinely analyze budgetary and proprietary account relationships and ensure that items are adjusted in a timely manner.

In addition, we found that year-end proprietary JV entries and budgetary adjustments were prepared and completed by different groups within RM. The proprietary entries and budgetary adjustments are also posted on different systems. The Department did not have formal written procedures outlining roles and responsibilities to ensure that adjustments were made in a timely manner and ensuring that different groups within RM reconciled adjustments to the proprietary and budgetary accounts.

Initially, RM indicated that one reason that the Department used the SF 133 Worksheets for budgetary adjustments instead of using the Hyperion system used for proprietary JVs was that Hyperion was not able to accommodate both budgetary and proprietary general ledger accounts. Because the Department was not using the same system to post the different types of adjustments, it posted over 2,600 budgetary adjustments at yearend through the use of the SF 133 Worksheets. However, during additional discussions with RM officials, we determined that the Hyperion system does have the ability to handle both budgetary and proprietary general ledger accounts but that RM was not using this ability.

Root Causes

- ***Lack of appropriate accounting policies and procedures.***
  The Department had not documented appropriate accounting policies and procedures for recording budgetary adjustments at yearend. This caused inconsistencies in recognizing, recording, and documenting accounting events and adequately reporting them in the Department's financial statements and AFR. The budgetary adjustments that we reviewed included little or no documentation or analysis to support the purpose of the adjustments.

- ***Lack of periodic account analysis.***
  The Department does not have a process in place to ensure that effective fund reconciliations are performed at the transaction level in a timely manner. At the end of FY 2009, the Department processed numerous budgetary adjustments designed to correct invalid entries or mistakes in posting to fund symbols for fund activities processed during the accounting period. These adjustments could have been entered properly or corrected at the transaction level if they had been identified in a timely manner. However, because they were not identified until after the end of the fiscal year, they were instead adjusted and processed using budgetary adjustments at yearend and did not include transaction-level detailed information.

- ***System configuration/limitations.***
  The Department maintains the SF 133 Worksheets outside of the Department's primary financial statement reporting package, which is Hyperion. The Department does not

utilize the full functionality of the Hyperion system to capture and control all accounting events (including budgetary transactions) and automate end-of-year reporting procedures. The Department's manual process for adjusting entries outside of the Hyperion system hinders its ability to complete year-end close efficiently and in a timely manner.

3. Non-Uniform Budgetary Adjustments Were Unsupported

In addition to the uniform budgetary adjustments made at yearend, the Department also makes other budgetary adjustments. These budgetary adjustments are also made using the SF 133 Worksheets and can be made for many different purposes. We reviewed the adjustments for all fund symbols. We were unable to identify an underlying reason for the other budgetary adjustments during our audit work; the Department did not have a uniform methodology for making these adjustments. The Department identifies adjustments that are not uniform in the SF 133 Worksheets as "Column E" and "Column M." "Column E" and "Column M" adjustments comprised 22 percent of the total dollar value of budgetary adjustments made. The SF 133 Worksheets did not include any supporting documentation or explanation about the purpose of the adjustments. RM officials indicated that fund managers retain information regarding the adjustments in those columns; however, we were unable to obtain this information and confirm support for the adjustments. At the time of our audit, the Department was in the process of conducting further research on these adjustments.

Root Causes

- ***Lack of appropriate accounting policies and procedures.***
  The Department had not documented appropriate accounting policies and procedures for recording non-uniform budgetary adjustments at yearend. This caused inconsistencies in recognizing, recording, and documenting accounting events and adequately reporting them in the Department's AFR. For example, the supporting documentation retained by fund managers to support the non-uniform budgetary adjustments varied. The Department does not have standard requirements for adjustments made to "Column E" and "Column M" in the SF 133 Worksheets.

- ***Insufficient management review of budgetary adjustments.***
  We found that management did not perform sufficient detailed reviews of the non-uniform budgetary adjustments to ensure that the adjustments were valid, which led to additional corrective entries. If management had conducted a detailed review of initial non-uniform budgetary adjustments, fewer corrective entries would have been needed. Additional review of the budgetary adjustments could decrease the chance for errors.

- ***Lack of periodic account analysis.***
  The Department did not have a process in place to ensure that effective fund reconciliations were performed at the transaction level in a timely manner. At the end of FY 2009, the Department processed numerous non-uniform budgetary adjustments designed to correct invalid entries or mistakes for activities that occurred during the accounting period. These adjustments could have been entered properly or corrected at

the transaction level if they had been identified in a timely manner. However, because they were not identified until after the end of the fiscal year, they were adjusted and processed using budgetary adjustments at yearend and did not include transaction-level detailed information.

- ***System configuration/limitations.***
The Department maintains the SF 133 Worksheets outside of the Department's primary financial statement reporting package, which is Hyperion. The Department does not utilize the full functionality of the Hyperion system to capture and control all accounting events (including budgetary transactions) and further automate end-of-year reporting procedures. The Department's manual process for adjusting entries outside of the Hyperion system hinders its ability to perform its fiscal year-end processes related to financial reporting efficiently and in a timely manner.

Figure 3: Summary of Conditions and Related Root Causes

	1. Non-Routine Correcting Entries Comprise 54% of Year-End JV Adjustments	2. Budgetary Adjustment Methodologies Were Not Adequately Supported	3. Other Budgetary Adjustments Were Unsupported
Lack of appropriate accounting policies and procedures	X	X	X
Insufficient management review	X	-	X
Lack of periodic account analysis	X	X	X
Lack of effective review to ensure proper accounting event entries	X	-	-
System configuration/limitations	-	X	X

Source: Kearney prepared based on analyses of root causes.

DEPARTMENT'S PLANNED ACTIONS/EVENTS

An effective and efficient CAP ensures that planned actions are created to address root causes instead of symptoms, reducing the risk that the planned actions will not be successful. Some root causes will be more critical than others. A well-developed CAP reflects this prioritization and focuses available resources on addressing high priority root causes. Management's performance of a root cause analysis ensures that planned actions/events are drafted to address specific root causes versus addressing the result of the deficiency (for example, conclusions drawn during an audit).

The Department's financial reporting CAPs consisted of 12 planned actions related to the financial reporting process. The Department included steps to analyze and review financial reporting processes through June 2010 and establish new control documents by July 2010. As of the date of this report, RM had not provided us with its planned analysis or new control documents. RM plans to evaluate the effectiveness of new procedures by October 2010.

The Department's planned actions and events are focused on analyzing functional areas in order to determine the root causes of the financial reporting deficiencies. However, the CAP does not include steps to address the underlying causes of the deficiencies that we identified during our analyses. In order to address the financial reporting deficiencies, it is essential for the Department to prepare a complete CAP for the financial reporting area.

Recommendation 1. We recommend that the Department of State perform a formal root cause analysis of financial reporting deficiencies and develop planned actions to address each root cause. The functional areas of analysis identified in the Department's financial reporting corrective action plans, along with our analysis included in this report, provide useful information to begin the process.

Management Response and Auditor Reply
RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

LEVEL-OF-EFFORT ANALYSIS

An effective CAP includes attainable milestones that allow the user to effectively monitor the remediation process. The development of a CAP should include the matching of resources to planned actions. This type of level-of-effort analysis should be used to set task milestones based on work required and resources needed to meet milestones. As part of the level-of-effort analysis, the Department should assess task dependency, which would identify tasks that depend on the completion of other tasks.

We noted that the financial reporting CAPs did not state the resources required for each planned action/event. Although a formal level-of-effort analysis was not performed, each team leader set the original plan target dates and was responsible for ensuring that the target dates were achievable with the resources available. The Department did not indicate important factors relating to resource estimates required to effectively complete the tasks associated with the corrective actions. We believe that a level-of-effort analysis, including a dependency analysis, should be performed to support the target dates set by each team leader.

Recommendation 2. We recommend that the Department of State perform a formal level-of-effort analysis for each planned action/event contained in the financial reporting corrective action plans to match resources to the planned actions and timelines and that it include this information in the corrective action plans.

Management Response and Auditor Reply
RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

RESPONSIBILITY AND ACCOUNTABILITY

Proper responsibility and accountability at both the management and staff levels must be assigned to ensure effective implementation of the CAP. The CAP must clearly assign planned actions/events to the individual team members responsible for performing the tasks and to officials responsible for planning, controlling, and closing the task. Responsibility ensures that management is held accountable for maintaining and updating the CAP.

We noted designations of task owner, team leader, and areas of responsibility within the Department's CAPs. For a majority of the planned actions, the task owner/point of contact was the same individual as the team leader. In addition, in most cases the area of responsibility listed an office or a bureau rather than an employee.

Management should be responsible for ensuring that milestones are achieved and that the validation phase is completed once corrective actions are implemented. Oversight of the tasks ensures that issues that could prevent the completion of some tasks are identified and reported to management.

Recommendation 3. We recommend that the Department of State assign tasks in the financial reporting corrective action plans at a level lower than that of the team leader. We also recommend that the Department formalize the accountability process that will be used to ensure that the corrective action plans are implemented to remediate the financial reporting control deficiencies. The Department should leverage the Circular A-123 governance structure, including the Senior Assessment Team, to monitor and track the completion of the corrective action plan milestones.

Management Response and Auditor Reply
RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

MILESTONES AND TRACKING STATUS

Circular A-123 states, "Management should track progress to ensure timely and effective results." Proper implementation of appropriate corrective actions requires the establishment of critical path milestones and checkpoints to measure overall progress of the corrective actions and identify any adjustments that would have to be made to the overall achievement date as a result of delays.

Creation of measureable milestones is an important step in determining planned start and end dates for all supporting actions/events. The process should include a review of the amount of time and resources needed to perform each task. This would serve as a baseline against which progress can be tracked. Measurable milestones allow the Department to effectively monitor the CAP process. Management should be able to easily determine whether the task started on time, how much work remains to be completed, and whether the task is scheduled to be completed on time. In addition, a dependency analysis should be performed as part of the schedule development to identify planned actions/events that cannot begin until the initiation or completion of other planned actions/events to ensure that the timeline is accurate.

The Department's financial reporting CAPs had estimated completion dates for the actions or events but did not include start dates. In addition, completion dates were not always stated for each subtask. In addition, we did not note any milestones in the CAPs that would allow the Department to ensure that deadlines would be met or that progress had been made. More detailed milestones will allow more effective monitoring of CAPs.

Recommendation 4. We recommend that the Department of State expand on the current milestones in the corrective action plans to include critical tracking metrics, such as key interim milestones, baseline and actual start and end dates, percentage of completion, and other status indicators, in its financial reporting corrective action plans.

Management Response and Auditor Reply
RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

PERFORMANCE METRICS AND VALIDATION

The creation of performance metrics should specifically describe a desired outcome and how it will be measured. The measurement must be quantifiable; its goal should not be just to meet the planned schedule dates. Performance metrics ensure that planned outcomes are properly evaluated.

During our review of the Department's financial reporting CAPs, we noted that the CAPs stated the types of evidence created by each planned action or event but did not contain metrics to indicate the effectiveness of the implementation of planned actions/events.

Recommendation 5. We recommend that the Department of State develop performance metrics to determine whether planned actions or events are complete and whether the outcomes effectively correct financial reporting-related internal control deficiencies.

Management Response and Auditor Reply
RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

We also noted that each of the financial reporting CAPs contained a "How will we know?" section. The CAP related to proprietary financial reporting indicated that the determination of the CAP completion would be that proprietary financial statements are timely and complete. The CAP related to budgetary financial reporting indicated that the determination of the CAP completion would be that the SBR is timely and complete. In addition, each CAP included the following items to validate the effectiveness of the CAPs:

- Key year-end deliverables and audit requests are provided by the agreed-upon dates.
- The independent auditor issues an audit opinion by OMB's due date.
- The independent auditor's report on internal controls for the audited financial statements disclosed no financial reporting internal control weaknesses for financial reporting classified as significant deficiencies.

These measures create significant reliance on the financial statement audit to determine whether the CAP has been successful. The Department also risks addressing only a subset of causes at a high level and not fully addressing all root causes. Since responsibility for adequate internal controls is inherently a management responsibility and financial reporting includes other types of financial reports and information in addition to the financial statements, an internal validation performed by management is appropriate.

Recommendation 6. We recommend that the Department of State include a validation methodology in its financial reporting corrective action plans that leverages its Circular A-123 internal control assessment and testing process.

Management Response and Auditor Reply

RM stated that it did not have any "substantive comments" on this recommendation and that it "will continue to enhance the CAPs by incorporating [the] recommendations" included in this report. Based on this response, this recommendation is considered resolved.

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June 1, 2010

APPENDIX A – OBJECTIVES, SCOPE, AND METHODOLOGY

The Office of Inspector General (OIG) requested that Kearney & Company, P.C. (referred to as "we" or "our" in this report), audit the Department of State's (Department) corrective action plans (CAP) related to financial reporting material weaknesses reported during the audit of the Department's FY 2009 financial statements. We performed this audit in order to assess the Department's efforts to develop CAPs to effectively address internal control weaknesses. Specifically, the primary objectives of the audit were the following:

- Identify root causes of the financial reporting control weaknesses through additional analyses of audit findings.
- Determine whether the Department has developed a CAP for financial reporting.
- Assess the adequacy of the Department's financial reporting CAP to successfully address and resolve financial reporting deficiencies.
- Make recommendations on how the Department may improve its financial reporting CAP and better address root causes.

Our audit was limited to a review of the draft CAPs provided by the Department on March 30, 2010. These CAPs were developed to address the financial reporting internal control deficiencies that contributed to the material weakness in the financial reporting process described in the report on internal controls for the audit of the Department's FY 2009 financial statements. Our scope did not include procedures on any other CAPs created by the Department. The Department was in the early stages of its CAP development and implementation process, and accordingly, management represented that its CAP will continue to be modified throughout the year. Furthermore, our audit included the review of the CAP itself and did not include the outcomes to be achieved as a result of the procedures outlined in the CAP.

Our analyses of root causes focused on the period between the closing of the Global Financial Management System and the Department's production of its financial statements included in its FY 2009 Agency Financial Report. We believe this scope provided the greatest value to identify the underlying reasons associated with financial reporting deficiencies.

We conducted this audit from February through May 2010 in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Bureau of Resource Management provided formal comments to the draft report, which are incorporated as appropriate and included in their entirety as Appendix B to this report.

Criteria for Assessing the Quality of the Department's Financial Reporting CAPs

GAGAS requires the establishment of performance criteria identifying the required or desired state or expectation with respect to the program or operation being audited. We reviewed

Federal guidance and industry benchmarks for CAP design and then created and received OIG approval for the following agreed-upon performance criteria for assessing the adequacy of the CAP:

- **Identification of Root Causes**: Confirmed that identified root causes were explicitly stated in the CAP and linked to planned actions or events.

- **Planned Actions or Events**: Substantiated that planned actions in the CAP addressed all root causes.

- **Level-of-Effort Analysis**: Verified that the number of resources required to achieve stated milestones was identified in the CAP. Confirmed that resources had been assigned and documented in the CAP to meet level-of-effort estimates for the duration of planned actions.

- **CAP Responsibility**: Validated that accountable officials, project leads, and key participants were identified in the CAP. Assignments should distinguish who may be held accountable for the execution, completion, and final approval of planned actions.

- **Milestones and Tracking Status**: Confirmed that the CAP contained critical tracking metrics, including baseline start/end dates, baseline duration, actual start and end dates, actual duration, remaining duration, percentage of completion, key milestones, and management status indicators (for example, on-track, delayed, or complete).

- **Performance Metrics and Validation**: Confirmed that the CAP identified key performance metrics to ensure that planned outcomes were achieved. Verified that the CAP contained measurable activities or standards for completeness that would provide evidence to support closure of the CAP.

Phase I – Planning/Understanding

The planning/understanding phase was designed to obtain insight into expected and/or required business requirements, current processes, procedures, and organizational structure with regard to financial reporting. We leveraged the results of the FY 2009 audit to confirm our understanding of the nature and profile of Department operations, accounting standards, regulatory requirements, and supporting information systems and controls. Based on the review of FY 2009 audit documentation, we performed a preliminary root cause analysis. We focused on critical areas for financial reporting: timeliness, operational procedures, and justification of end-of-period journal vouchers (JV) recorded in Hyperion; timeliness, operational procedures, and justification of end-of-period budgetary adjustments; and reconciliation of proprietary and budgetary accounting related to end-of-period adjustments.

Combined with our review of existing evidence and supporting process documentation for the selected critical process areas and preliminary root cause analysis, we conducted interviews with key individuals and groups in the Department who were impacted by or could affect the successful completion of the processes in our scope. We conducted interviews with key personnel at the Bureau of Resource Management, including the Office of Financial Policy, Reporting, and Analysis, and the Global Financial Services Center in Charleston, South Carolina. These interviews were conducted to identify the root causes of the financial reporting control deficiencies identified during the FY 2009 financial statement audit and determine whether the Department had developed a CAP that would address the identified root causes. The Department's discussion about the CAPs allowed us to assess the Department's approach and obtain clarification for information documented in the CAP.

Phase II – Analysis

The criteria agreed upon in the understanding/planning phase served as the basis for assessing the adequacy of the Department's development and implementation of corrective actions to successfully resolve the root causes of the identified deficiencies. We determined whether relevant CAP protocols were incorporated into the Department's plans. Beyond structure and compliance, we determined whether the identified root causes were addressed by the planned actions/events as stated in the CAP.

Phase III – Reporting

After conducting our analysis in Phase II, we formulated our findings and recommendations for each agreed-upon performance criterion.

APPENDIX B – BUREAU OF RESOURCE MANAGEMENT RESPONSE

United States Department of State

Chief Financial Officer

Washington, D.C. 20520

JUL 27 2010

UNCLASSIFIED

MEMORANDUM

TO: OIG – Harold W. Geisel (Acting)

FROM: RM – James L. Millette JM

SUBJECT: Draft Audit Reports of the Department of State Corrective Action Plans for Real Property, Personal Property and Equipment, and Financial Reporting.

This responds to your request in your July 8, 2010 Memorandum for comments on the above referenced Reports.

We have reviewed Kearney and Company's (Kearney) draft reports prepared for the OIG on the above-referenced subjects and met with Kearney and the OIG on the information presented. We do not have any substantive comments on the reports' recommendations at this time.

As we have discussed with Kearney over the last several months, we continue to concentrate our efforts and attend to those elements in the corrective action plans (CAPS) that will address the material weaknesses reported in the FY 2009 Independent Auditor's Report on the Department's Financial Statements. We are pleased that the review found no significant elements missing in the CAPS that would prevent the Department from addressing these issues for this year's audit. We will continue to enhance the CAPS by incorporating your recommendations for improvements as well as those that we identify through our on-going efforts.

RM appreciates the opportunity to comment on the report.

Unclassified

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of Federal programs
and resources hurts everyone.

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