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 Plan for Real Property* (AUD/FM-10-28)

The subject report, prepared by Kearney & Company, P.C., an independent external auditor, is attached for your review and information. Kearney & Company incorporated your comments as appropriate within the body of the report and included them in their entirety as Appendix C.

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

United States Department of State
and the Broadcasting Board of Governors

Office of Inspector General

AUG 25 2010

MEMORANDUM

TO: OBO – Mr. Adam E. Namm, Acting

FROM: OIG/DIG – Harold W. Geisel

SUBJECT: Report on the *Audit of Department of State Corrective Action Plan for Real Property* (AUD/FM-10-28)

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: OBO/RM – Jurg Hochuli
RM/DCFO – Chris Flaggs
Kearney & Company, P.C. – David Zavada

U.S. Department of State

Audit of the Corrective Action Plan for Real Property

AUD/FM-10-28

August 2010

KEARNEY & COMPANY

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June 18, 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 real property 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 18, 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 plan (CAP) developed to address internal control deficiencies identified during the course of the FY 2009 financial statement audit in the area of real property accounting. 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 effectively address internal control weaknesses. During this audit, we performed additional analyses to identify underlying causes of deficiencies reported during the FY 2009 financial statement audit, reviewed the draft CAP provided by the Department, and conducted follow-up interviews with key Department personnel involved in the real property accounting process. We assessed the quality of the Department's CAP using criteria adapted from best practices for well-developed CAPs and OMB guidance, all of which were accepted by OIG.

We found that the Department did not perform a formal root cause analysis to identify the underlying causes of the real property deficiencies. Instead, management relied on its existing knowledge about the causes of the real property internal control weaknesses and the FY 2009 financial statement audit report. As a result, the planned actions only partially address the root causes we identified in our audit. However, we believe that the Department's planned actions or events will create compensating controls that, if put in place, will address several of the reported deficiencies.

We believe that the Department should perform additional analyses to better develop the root causes of the real property deficiencies and integrate its findings into the CAP. In addition, we believe that the Department could improve the quality of the real property CAP by taking the following actions:

- 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.
- 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

In its response, the Bureau of Overseas Buildings Operations (OBO) agreed with Recommendations 1 and 2 and 4 to 6, which related to performing a root cause analysis of real property accounting deficiencies and including a level-of-effort analysis, tracking and performance metrics, and validation methodology. However, OBO did not agree with Recommendation 3, which related to assigning specific tasks at the staff level. OBO indicated that the CAP correctly identifies the managers responsible for each task and it is the manager's responsibility for assigning and monitoring the work associated with each task. We believe an effective CAP clearly assigns tasks to both the team member who is performing the task and to the supervisor who is overseeing the work. The clearly defined roles and responsibilities for completing the project will strengthen commitment from assigned team members and will allow accountable officials to see where gaps exist compared with estimated resource requirements.

The Bureau of Resource Management (RM) generally concurred with the recommendations in the report. RM indicated that it plans to continue to enhance the CAP by incorporating the report's recommendations and other improvements that RM identifies through its ongoing efforts.

OBO's response and RM's response to the draft report are included in Appendices B and C, respectively.

BACKGROUND

Real property is any interest in land, together with structures, fixtures, and improvements of any type located thereon. Real property is associated with realty, land, or something attached thereto. The major classes of real property are land, buildings, construction-in-progress (CIP), capital leases, land improvements, and leasehold improvements. Most of the Department's real property is located overseas, though some is located domestically. In its FY 2009 financial statements, the Department reported a net value for real property of approximately $11 billion. However, because the Department was unable to provide timely and competent evidential material related to property and equipment, we were unable to complete audit procedures on this line item.

FINANCIAL STATEMENT AUDIT DEFICIENCIES RELATED TO REAL PROPERTY

For FY 2009, we assessed the Department's property account as a material weakness based on the pervasiveness of the identified deficiencies in internal control related to property (real, personal, leased, and software) and the related risk of a material misstatement in the financial statements.[1] The Department's internal control structure exhibited several deficiencies that negatively affected the Department's ability to account for real property in a complete, accurate, and timely manner. For instance, we identified issues related to land valuation, identification and valuation of assets and liabilities under capital leases, completeness and accuracy of real

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

property, and accuracy of CIP transactions. Specifically, we noted the following issues related to real property:

- **Land Valuation** – The Department reported $2.2 billion of land and land improvements in FY 2009. We identified errors in land valuation. For instance, the Department's land balance, carried forward from years prior to 2008, included nine individual parcels of land with a combined value of $456 million. The nine parcels were related to two specific prior period transactions. The Department had erroneously recorded these parcels without discounting estimated values back to the year of acquisition consistent with the Department's stated policy. The Department processed a restatement to write down the value of these land parcels to a combined value of $58 million.

- **Capital Leases** – The Department manages approximately 7,500 real property leases. In determining leases that qualify as capital leases under Generally Accepted Accounting Principles (GAAP), the Department did not apply one of the four capital lease evaluation criteria, specifically, net present value (NPV) of minimum lease payments in excess of 90 percent of fair market value (FMV). In order to comply with this criterion, the Department should record an asset under capital lease, typically for the NPV of the minimum lease payments.

- **Completeness and Accuracy of Real Property** – The Department reported a net value of $11 billion in real property assets as of September 30, 2009. The Department has not completed a reconciliation of the overseas real property listed in its general ledger to the properties tracked in its overseas real property management system. Efforts to reconcile real property records for a sample of international posts identified numerous errors and reconciling items.

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

SCOPE AND METHODOLOGY

Correcting the deficiencies related to real property in an organization as broad in scope and 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 CAP related to real property, we considered these components of a well-developed CAP to be criteria. Each of these criteria is discussed in greater detail in Appendix A, which provides additional information on the scope and methodology of the audit.

RESULTS

ROOT CAUSE ANALYSIS

Identifying root causes is a critical first step in establishing a well-developed CAP. 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 in the real property accounting 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 a CAP related to real property. The Department's CAP identifies areas where it will perform steps to address deficiencies. However, the CAP appears to have been based on management's existing knowledge and understanding of underlying causes and the FY 2009 financial statement auditor's report rather than on a formal root cause analysis following Department guidance. As a result, the planned actions only partially address the root causes we identified in our audit. The Department identified four areas where corrective actions are planned:

1. Property Reconciliations – Perform complete reconciliation between the financial system and the property management system and establish processes to conduct reconciliations periodically.

2. Reporting on Capital Leases – Refine processes used to calculate capital leases, to include reviewing applicable accounting standards, capturing amended lease terms in capital lease calculations, developing procedures to create formal amortization schedules, developing procedures to assess the FMV of leased property where applicable, and accurately depreciating capital leases.

3. Recording CIP Transactions – Review processes to record CIP and revise as needed.

4. Land Valuation – Review previously recorded land valuation for property.

Based on our additional analysis of the deficiencies identified and reported during our FY 2009 financial statement audit, we identified areas where underlying causes resulted in internal control deficiencies in the real property area. Not all of these issues were addressed in the Department's real property CAP. 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. Land Valuation Work Performed by Contractor Was Not Reviewed

The Department did not conduct adequate management reviews of the work performed by a contractor to value land that was included in the beginning balances of the FY 2009 financial statements. The error related to the calculation of the value of the land dating back to 1996. We identified the error during our analytical review of property balances recorded in the real property management system and the financial system. Certain parcels of land acquired as gifts from host countries were not discounted back to the date of the gift. Department management recorded an adjustment to decrease the value of these parcels from $456 million to $58 million to correct the error.

2. Management Believes It Is Not Cost Effective To Obtain the FMV of All Leased Properties in Order To Be GAAP Compliant

The Department does not currently assess the FMV of leased property to ensure that the NPV of lease payments exceeds 90 percent of the FMV as required under GAAP. Department officials indicated that the amount of time and resources necessary to obtain the FMV of all leased property is not cost beneficial, since the Department generally enters into short-term lease agreements.

3. Accuracy and Timeliness of Recording Capital Lease Information Was Not Reviewed

The Department maintains thousands of leases in over 200 posts. Because of this decentralized operating environment, the Department relies on the posts to update lease information in the Real Property Application (RPA). However, we found that not all posts were recording lease information accurately or in a timely manner. The management review process in place does not sufficiently prevent, detect, or correct data entry errors, nor does it ensure that lease information is complete in RPA. In addition, the review process does not identify lease information that has not been updated. The information in the RPA lease listing serves as the basis for capitalization decisions and financial reporting functions, making it a critical element to accurate financial data.

4. Capital Lease Schedules Are Not Automated

The Department utilizes a Microsoft (MS) Excel tool to manage capital lease schedules and related financial calculations rather than an automated lease management application. Capital lease information is manually loaded and manipulated in the MS Excel tool, making the Department's lease schedules prone to human error. Additionally, the MS Excel tool was not designed to effectively capture amortization and depreciation schedules.

5. Accounting and Real Property Management Systems Are Not Integrated or Interfaced

The Department's accounting system and the real property management system were not designed to have interface functionality, thereby requiring mitigating controls to counter the lack of an interface. The Department did not have any mitigating controls to detect differences between the two systems during the audit of the Department's FY 2009 financial statements. For instance, disposals of real property were recorded in one system but not in another. Additionally, the Department did not have a universal coding structure to readily and consistently identify real property between the two systems, leading to different tracking mechanisms and standards and making reconciliation difficult.

6. No Process Was In Place To Identify and Correct Errors Made Prior to FY 2006

Prior to FY 2006, when the Department established a Real Property Team at the Global Financial Services Center in Charleston, South Carolina, standardized roles and responsibilities had not been communicated to relevant stakeholders responsible for updating the Global Financial Management System (GFMS) with RPA data. We noted several instances where transactions were entered into RPA but not subsequently updated in GFMS. No clear responsibility existed for the ongoing reconciliation of information in both systems. The lack of clearly defined accounting roles and responsibilities contributed to the creation of reconciling items.

The Real Property Team should ensure that no new reconciling items occur. However, we noted that the quarterly data call process implemented in FY 2006 required the Real Property Team to focus on reconciling current additions and deletions. Therefore, legacy issues were not identified or corrected. The Department did not implement any compensating controls to detect and correct these issues.

7. Department Policies and Procedures Are Not in Place To Accurately Capture Capitalizable Costs

<u>Capitalization Determination</u>

The current Department policy with respect to the capital versus expense determination requires that all improvements over $1 million be capitalized. However, the criteria set forth in Statement of Federal Financial Accounting Standards (SFFAS) No. 6, Accounting for Property, Plant, and Equipment, indicates that cost should be only one consideration for determining whether improvements should be capitalized. The other items that should be considered are whether the asset's useful life is extended and whether there is an improvement in the building's capacity. The Department does not assess expenses to determine whether they should be capitalized or not.

Indirect Cost Allocation

Formal Departmental policies and procedures to analyze and capitalize the amounts retained from contractors are not in place. Currently, the indirect cost allocation process calls for the posting of indirect costs once a year and not at the time that project completion is recorded. This process results in costs that are not recorded in the period in which they are incurred, which the Department calls "lagging costs."

DEPARTMENT'S PLANNED ACTIONS/EVENTS

The Department's CAP consisted of 22 planned actions related to real property accounting, with an anticipated completion date of FY 2011. We found that the CAP did not include steps to fully address the root causes of the real property deficiencies that we identified in our analyses. The Department had not performed a formal root cause analysis to identify the underlying causes of the real property deficiencies. Instead, management relied on its existing knowledge about the underlying causes and the FY 2009 financial audit report to determine actions to address the control weaknesses.

The CAP included steps to reconcile the property management system to the accounting system, address deficiencies related to capital leases, improve the process for recording CIP transactions, and correct instances of incorrectly valued land. We believe that the planned actions or events will create compensating controls or processes that, if put in place, will address several of the identified deficiencies. We compared the root causes that we identified with the Department's planned actions to identify issues that were not being addressed.

Land Valuation – The Department's real property CAP included actions to reconcile the consultant's data files to property, plant, and equipment as presented on the balance sheet as of September 30, 1996. The Department plans to further review and assess the appropriateness and accuracy of "scrub-down" adjustments effected as of September 30, 1997, and revalue any assets that it determines were recorded incorrectly using cost information published by the International Monetary Fund. Although the CAP does not specifically address the inadequacy of the review over the land valuation work performed by a contractor that we identified as a root cause, the steps included in the CAP address the underlying deficiency related to land valuation. This deficiency related to work performed by a contractor in FY 1996 to determine the historical cost of certain Department assets. Because the Department records the cost of newly acquired assets, it is unlikely that the Department will need to use a contractor to value assets in the future. Therefore, we believe that the planned actions are reasonable.

Capital Leases – The Department's CAP included plans to identify appropriate capital lease methodologies and accounting treatment for overseas lease agreements and use that information to ensure compliance with accounting standards. The Department also intended to obtain accurate lease information and ensure that it is included in the listing of leases. This effort would include capturing amended lease terms in capital lease calculations, developing procedures to create formal amortization schedules, developing policies and procedures to assess FMV of leased property, and appropriately depreciating capital leases. In addition, the Department

planned to identify capitalization software that could effectively and efficiently assist in the calculation of capital lease amounts and calculate annual amortization amounts in compliance with Federal accounting standards.

The CAP includes a step to develop policies and procedures to assess the FMV of leased property, which is a required element to consider in determining which leases should be capitalized. The CAP also indicates that the Deputy Chief Financial Officer (DCFO) and the OBO would determine the feasibility of measuring the FMV of leased property. However, during fieldwork, Department officials indicated that they were concerned with the cost of obtaining the FMV of the leased assets. The officials indicated that since most of the Department's leases were short term, it might not be worthwhile to obtain the value of the asset. Therefore, the Department's planned actions may not obtain the required FMV information.

We also found that the CAP did not provide specific planned actions to address the need to enter timely and accurate lease information into RPA at the posts. The CAP indicates that the DCFO will coordinate with OBO to ensure all capital leases, including amendments and modifications, have been accurately, completely, and timely recorded in the RPA. Additionally, the CAP includes a step to ensure that all applicable lease information required for testing of capitalization is present in the Department's lease listing. Conceptually, these two actions speak to the identified root cause; however, the CAP does not include specific steps on how the Department intends to ensure required information is accurate, complete, and timely. The CAP also does not indicate how the DCFO and OBO will enhance coordination efforts with posts. Therefore, we do not believe the CAP sufficiently addresses the root cause that we identified related to reviewing the capital lease information to ensure it is accurate, complete, and timely.

The Department's CAP included actions to identify an automated tool that can effectively and efficiently assist in the calculation of the capital lease amount and also calculate annual amortization amounts in compliance with Federal accounting standards. This step would sufficiently address the root cause we identified related to automating capital lease schedules. When the Department selects the new system, it should properly define system requirements prior to software demonstration and selection to ensure an effective and timely implementation process.

Because the CAP does not include steps to sufficiently address two of the root causes we identified, the capital lease-related deficiencies may not be fully addressed.

Completeness and Accuracy of Real Property – The Department's real property CAP included planned actions to perform a complete real property reconciliation between the Department's property management and financial system of record, which would include items entered into the system prior to FY 2006. The Department plans to implement a process to ensure that reconciliations are performed on an ongoing basis in the future. The Department's CAP does not include any planned actions to integrate the financial management and real property management systems, which is one of the root causes that we identified. It does, however, include steps to review the current data to ensure that the information entered prior to FY 2006 is complete and accurate, which is another root cause. We believe that these steps, if performed, would be

reasonable to address the deficiencies we noted during the audit of the FY 2009 financial statements related to the completeness and accuracy of the real property information in the financial system.

Accounting for CIP – The CAP included planned actions to provide additional guidance and training to posts, construction groups, and others on reporting and documentation requirements for capitalized projects regarding accuracy and timeliness for reporting. The Department plans to complete an OMB Circular A-123, Appendix A, review of the processes for recording CIP with accompanying findings and recommendations. It also plans to perform a complete review quarterly of new OBO projects designated as a capitalized project type. The indirect cost allocation process will also be modified by RM. The Department will identify issues related to the quarterly data call process. OBO will verify that the Building Management Information System (BMIS) has been updated to reflect all changes resulting from the quarterly data call information provided to RM.

We believe that the Department's CAP partially addresses the root cause of this deficiency. However, there are no planned actions to revise the Department's capitalization policies to comply with SFFAS No. 6, which indicates that costs should be only one consideration for determining whether improvements should be capitalized.

The identified root causes compared with the planned actions included in the CAP are summarized in Table 1.

Table 1. Root Cause to Planned Actions Crosswalk

	Root Cause	Does the CAP Adequately Address Root Cause?	CAP Identification Number	CAP Description
1	Land Valuation Work Performed by Contractor Was Not Reviewed	No	4A.	Reconcile Price Waterhouse Coopers (PW) data files to Property, Plant & Equipment (PP&E) as presented on the Department's balance sheet as of September 30, 1996.
			4B.	Review and assess the appropriateness and accuracy of "scrub-down" adjustments effected as of September 30, 1997.
			4C.	Review PW data file and extract assets where the amounts in APPRCURR and AppAcqCost are equal (calculated value as of September 30, 1996, was not reduced to a value at date of acquisition)
			4D.	Using consumer price index (CPI) and exchange rate data from *International Financial Statistics*, published by the International Monetary Fund, and the protocol used by PW, deflate the 1996 value (APPRCURR) to the value at the date of acquisition (AppAcqCost).
			4E.	Calculate the effect of this revaluation (i.e., 4.D) and develop an adjustment to be made to PP&E if necessary.
			4F.	Review and assess the appropriateness and accuracy of asset amounts recorded for 1999 and later.
2	Management Believes It Is Not Cost Effective To Obtain the FMV of All Leased Properties in Order To Be GAAP Compliant	No	2A.	Establish best practices based on industry benchmarks.
			2B.	Ensure compliance with accounting standards.
			2C.	Obtain accurate lease information.
3	Accuracy and Timeliness of Recording Capital Lease Information Was Not Reviewed	No	2C.	Obtain accurate lease information.
4	Capital Lease Schedules are not Automated	Yes	2D.	Identify an automated tool.
5	Accounting and Real Property Management Systems Are Not Integrated or Interfaced	No	1A.	Obtain point of contact at USAID and complete a detailed building/land comparison of USAID recorded assets versus the Building Management Information Systems (BMIS) asset records since BMIS includes USAID buildings/land (NFR 35 recommendation).
			1B.	Complete reconciliation of global financial management system detail asset records versus Bureau of Overseas Buildings Operations BMIS detail asset records for existence (NFR 35 recommendation).
			1C.	Review listing of all real property assets with a zero or nominal valuation and determine the proper valuation in conjunction with OBO available documentation.
			1E.	Require annual property certification of BMIS U.S. Government owned listing by designated post management.
6	No Process Was In Place To Identify and Correct Errors Made Prior to FY 2006	Yes	1D.	Develop methodology for determining the valuation for properties with no value in GFMS and no original OBO documentation available for original purchase/construction price or fair market value.
			1F.	Develop processes, controls, and procedures to ensure that reconciliations are performed on an ongoing basis in a timely and accurate manner.
7	Department Policies and Procedures Are Not in Place To Accurately Capture Capitalizable Costs	Partially	3A.	Work with the Bureau of Resource Management property accounting group to identify issues related to the quarterly data call process (NFR 21 recommendation).
			3B.	Provide additional guidance and training to posts and related parties on reporting and documentation requirements for capitalized project regarding accuracy and timeliness of reporting.
			3C.	A-123, Appendix A review, findings and recommendations of processes for recording construction-in-progress.
			3D.	Review new OBO projects designated as a capitalized project type on a quarterly basis. Obtain adequate detailed project description from OBO project managers (NFR 21 recommendation).
			3E.	Modify the indirect cost allocation process (NFR 21 recommendation).
			3F.	Verify that BMIS has been updated to reflect all changes resulting from quarterly data call information provided to RM/GFS.

Source: Kearney prepared based on analyses of root causes.

We do not believe that all of the real property deficiencies are sufficiently addressed in the real property CAP because the Department did not perform a formal root cause analysis in compliance with its internal standards.

Recommendation 1. We recommend that the Department of State perform a formal root cause analysis of real property accounting deficiencies and develop planned actions to address each root cause identified. Our analysis, included in this report, would provide useful information to begin the process.

Management Response and Auditor Reply
OBO agreed that a full root cause analysis should be conducted by the Department. Although OBO does not believe that the Department was given sufficient time to do such an analysis prior to the performance audit, OBO indicated that it will strive to address this deficiency. 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 the responses, this recommendation is considered resolved.

LEVEL-OF-EFFORT ANALYSIS

The development of an effective 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 real property CAP did not include the Department's estimated level of effort associated with each proposed corrective action. The CAP contained detailed breakdowns of tasks associated with specific corrective actions. However, 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 target dates.

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

Management Response and Auditor Reply
OBO agreed that an effective corrective action plan should include a level-of-effort analysis and stated that it plans to explore this once the Department is able to complete a full root cause analysis. 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 the responses, this recommendation is considered resolved.

RESPONSIBILITY AND ACCOUNTABILITY

Proper responsibility and accountability at both the management and staff level must be implemented 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 responsibility and accountability to management specific to the affected bureaus and offices within the real property CAP. The area of responsibility listed an office or bureau rather than a specific employee.

Management is 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. The CAP did not include any information on how the CAP would be evaluated or monitored. The Department could leverage the OMB Circular A-123, Appendix A, governance structure to monitor and track the CAP milestones.

Recommendation 3. We recommend that the Department of State assign tasks in the real property corrective action plan to specific task owners and that the Department formalize the accountability process that will monitor and track the completion of corrective action plan milestones.

Management Response
OBO did not agree with the recommendation, stating that the CAP "correctly identifies the managers responsible for each task and it is up to those managers to assign and monitor the work associated with each specific tasks." 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.

Auditor Reply
Based on the publication *Project Management Body of Knowledge*,[2] we concluded that an effective CAP clearly assigns tasks to both the team member who is performing the task and to the supervisor who is overseeing the work. The clearly defined roles and responsibilities for completing the project will strengthen commitment from assigned team members. The formal assignment of project staff members also directly interacts with other project management functions, including the level-of-effort analysis. Assigning available team members allows accountable officials to see where gaps exist compared with estimated resource requirements. Also, when task duration is estimated before all project team members are known, actual experience and competency levels of the assigned team members can cause the activity duration and project schedule to change. Based on OBO's response, this recommendation is considered unresolved.

MILESTONES AND TRACKING STATUS

OMB 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 identification of any adjustments that would have to be made to the overall achievement date as a result of delays.

[2] Project Management Institute, Inc., dated 2004 (ANSI/PMI 99-001-2004).

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 action/events to ensure that the timeline is accurate.

The Department's CAP had overall completion dates for the planned actions and events but did not include start dates or interim milestone dates. In addition, completion dates were not always stated for each subtask. The Department should establish interim milestones to monitor and track timely completion of each action/event. Detailed milestones will allow more effective monitoring of the CAP.

Recommendation 4. We recommend that the Department of State 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 real property corrective action plan.

Management Response and Auditor Reply
OBO agreed with the recommendation, stating that it will "strive to address these deficiencies." 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 the responses, 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; the goal should not be just to meet the planned schedule dates. Performance metrics ensure that planned outcomes are properly evaluated. The Department's CAP 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.

We also found that the Department's CAP contained a "How will we know?" section, stating that the determination of the CAP completion will be that real property data is timely, accurate, and complete and that comprehensive annual certifications are performed and received. We believe the management validation process should go further to verify that the CAP has been successfully completed and that internal controls are effective and provide evidence to support the closure and success of the CAP. The CAP indicates that one measure of success is that the external auditor's report on the financial statements discloses no real property internal control weaknesses classified as significant deficiencies. This measure creates 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 an inherent management responsibility, an internal validation performed by management is appropriate.

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

Management Response and Auditor Reply
OBO agreed with the recommendation, stating that it will "strive to address these deficiencies." 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 the responses, this recommendation is considered resolved.

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

Management Response and Auditor Reply
OBO agreed with the recommendation, stating that it "will strive to address these deficiencies." 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 the responses, this recommendation is considered resolved.

June 18, 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 real property deficiencies 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 real property control weaknesses through additional analysis of audit findings.
- Determine whether the Department has developed a CAP for real property accounting.
- Assess the adequacy of the Department's real property CAP to successfully address and resolve real property deficiencies.
- Make recommendations on how the Department can improve its real property CAP and better address root causes.

Our audit was limited to a review of the draft CAP, including an appendix related to capital leases, referred to as "Attachment A," as of April 12, 2010. The CAP was developed to address the real property internal control deficiencies that contributed to the material weakness in Net Property and Equipment described in the report on controls related to the audit of the Department's FY 2009 financial statements. Our scope did not include procedures on any other CAPs created by the Department. Management stated that its CAP will continue to be modified throughout the year. Revisions made to the CAP after April 12, 2010, were outside the scope of this audit. Furthermore, our audit was limited to a review of the CAP itself and not the outcome that would be achieved as a result of the procedures outlined in the CAP.

We conducted this audit from February through April 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 Overseas Buildings Operations (OBO) and the Bureau of Resource Management (RM) provided formal comments to the draft report, which are incorporated as appropriate and included in their entirety as Appendices B and C, respectively.

Criteria for Assessing the Quality of the Department's Real Property CAP

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/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 real property. 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 process areas for real property: financial accounting system reconciliations, accounting for capital leases, accounting for construction-in-progress (CIP), and land valuation determination.

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 OBO and RM, including the Office of Financial Policy, Reporting, and Analysis, and the Global Financial Services Center in Charleston, SC (GFSC-C). These interviews were conducted to identify the root causes of the real property 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.

During these interviews, the Department discussed its approach toward the CAP and how the CAP complements the efforts to correct the real property material weakness.

Phase II – Analysis

The criteria agreed upon in the planning/understanding phase served as the bases 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 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 OVERSEAS BUILDINGS OPERATIONS RESPONSE

United States Department of State

Director of the Bureau
of Overseas Buildings Operations

Washington, D.C. 20522-0611

JUL 27 2010

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MEMORANDUM FOR HAROLD W. GEISEL OIG/DIG

FROM: OBO – Jurg Hochuli, *Acting*

SUBJECT: Response to "Audit of the Corrective Action Plan for Real Property"

This memorandum provides the Bureau of Overseas Buildings Operations (OBO) response to Kearney & Company's draft report on their *Audit of the Corrective Action Plan for Real Property*. OBO agrees internal controls are an important and effective tool in assessing accountability throughout the Department. We also agree with the intent of the performance audit to assess our corrective action plan (CAP) for real property. An independent and objective review can bring new perspective and ideas. However, we believe that the result of this performance audit would have better served the Department if it has been conducted by an independent audit firm that was not directly connected with the annual financial statement audit.

The performance audit would have been more useful to the Department had it been completed in May in accordance with the schedule provided by Kearney during the entrance conference. Our hope was to utilize the performance audit to inform the FY 2010 financial statement audit. However, receiving the draft report in July is too late to make any substantive changes or improvements to the CAP in time for this fiscal year's audit.

One of the report's significant critiques is the lack of a root cause analysis to identify the underlying deficiencies reported in the FY 2009 financial statement audit. However, the FY 2009 financial audit concluded in December 2009 and OBO was informally notified of the performance audit on January 20, 2010, officially notified on March 2, 2010, and the entrance conference was held on March 17, 2010. As a result, the limited time available was used to focus the real property CAP only on the specific material weakness items addressed in the financial statement audit.

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OBO does not agree with the suggested root cause regarding the interface between the real property management and accounting systems. Since instituting the quarterly data call process, OBO believes the process deficiencies were resolved. The current data deficiencies pre-date the quarterly data call process. OBO and RM are resolving those deficiencies through the real property reconciliation outlined in the CAP.

OBO disagrees with the assertion that the Department does not have a universal coding structure for real property. In fact, the Department does have a universal coding structure which resides in the real property management system. The Department is currently working on a system change that will allow RM to correct the real property identifiers in the accounting system without impacting the financial statements. This will ensure that property identification numbers prior to FY 2006 match OBO's real property management system.

Recommendations

Recommendation 1. - OBO agrees that a full root cause analysis should be conducted by the Department. However, OBO does not believe that the Department was given sufficient time to do such an analysis prior to the performance audit.

Recommendation 2. - OBO agrees that an effective corrective action plan should include a level-of-effort analysis. This can be explored once the Department is able to complete a full root cause analysis.

Recommendation 3. - OBO does not agree with the recommendation to include the assignment of specific tasks to the staff level in the corrective action plan. The CAP correctly identifies the managers responsible for each task and it is up to those managers to assign and monitor the work associated with each specific tasks.

Recommendaton 4. – OBO agrees with the recommendation.

Recommendation 5. – OBO agrees with the recommendation.

Recommendation 6. OBO agrees with the recommendation.

OBO looks forward to working with Kearney and the OIG to address deficiencies. OBO will strive to address these deficiencies in a manner that is

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beneficial to the Department's mission to provide secure, safe and functional facilities around the world. In the face of diminishing resources it is imperative to have a balanced approach to ensure that we continue to effectively and efficiently meet our mission.

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APPENDIX C – BUREAU OF RESOURCE MANAGEMENT RESPONSE

United States Department of State

Chief Financial Officer

Washington, D.C. 20520

JUL 27 2010

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MEMORANDUM

TO: OIG – Harold W. Geisel (Acting)

FROM: RM – James L. Millette

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.

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