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MANAGEMENT LETTER
AUD/FM-11-04

To the Secretary and Inspector General of the U.S. Department of State

We (Kearney & Company, P.C.) have audited the consolidated financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2010, and have issued our report thereon dated November 14, 2010.[1] In planning and performing our audit of the Department's consolidated financial statements, we considered the Department's internal control over financial reporting and compliance in order to determine our auditing procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurance on internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control related to financial reporting and compliance. We have not considered the Department's internal control since the date of our report.

During our audit, we noted certain matters related to internal control over financial reporting and compliance that we considered to be significant deficiencies under standards established by the American Institute of Certified Public Accountants. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our report on internal control noted six significant deficiencies. Specifically, we noted concerns related to financial reporting, property and equipment, accounts payable accruals, budgetary accounting, the liability to international organizations, and information technology.

Our procedures were designed primarily to enable us to form an opinion on the Department's consolidated financial statements and therefore may not identify all internal control weaknesses that may exist. However, we would like to use the knowledge we gained during our audit of the Department to provide comments and suggestions that we hope can be useful to the Department.

Although not considered to be significant deficiencies, we noted certain other matters involving internal control and operations. These findings and recommendations, which are summarized in the appendix, are intended to assist the Department in improving internal control or to result in other operating efficiencies. These findings and recommendations have been discussed with appropriate Department officials.

[1] *Independent Auditor's Report on the U.S. Department of State 2010 and 2009 Financial Statements* (AUD/FM-11-03, Nov. 2010).

We appreciate the assistance provided by the Department's personnel during our audit. We would be pleased to discuss these comments and recommendations with the Department.

Comments by Department management on this report are presented as Appendix B.

This letter is intended solely for the information and use of Department management, those charged with governance, and others within the Department and the Office of Inspector General and is not intended to be and should not be used by anyone other than these specified parties.

Kearney & Company

February 25, 2011
Alexandria, Virginia

PRIOR YEAR MANAGEMENT LETTER COMMENTS – REMOVED

During the audit of the U.S. Department of State's (Department) 2009 financial statements, Kearney & Company, P.C. (Kearney), identified matters that it reported in a management letter.[1] As a result of additional work performed during the audit of the 2010 financial statements, Kearney did not include some of the prior findings in the current management letter.

- **Treasury Symbol 19F3875 – Budget Clearing Account, Suspense** – This issue was included in the "Report on Compliance and Other Matters" [2] as an element of the Antideficiency Act noncompliance finding, so it was removed from this management letter.

- **Improper Exclusion of Reimbursable Agreements From Deferred Revenue Calculation –** The Department modified the deferred revenue procedures during FY 2009 to include select Bureau of Overseas Buildings Operations agreements. This process was continued during FY 2010, and it effectively addressed the issue.

- **Untimely Disbursement of Payments to Vendors Pursuant to the Prompt Payment Act –** This issue was considered significant enough to include in the "Report on Compliance and Other Matters," so it was removed from this management letter.

- **Reconciliation and Approval of Charge Card Transactions Need Improvement –** Audit test work performed during FY 2010 identified no exceptions; therefore, the issue was closed.

- **Policies and Procedures for Estimation of the Foreign Service Retirement and Disability Fund Allowance for Doubtful Accounts Needs Improvement –** The Department did not mitigate the issue; however, audit work performed during FY 2010 concluded that the resulting impact was immaterial. The exception was reduced to a discussion item.

- **Foreign Currency Exchange Rate Review –** The Department did not develop policies and procedures to mitigate the issue; however, audit work performed during FY 2010 concluded that the resulting impact was immaterial. The exception was reduced to a discussion item.

- **Lack of Financial Disclosure Report –** During audit work, Kearney concluded that this issue was not significant to the financial statements. The exception was reduced to a discussion item.

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[1] *Management Letter Related to the Audit of the U.S. Department of State FY 2009 Financial Statements* (AUD/FM-10-18, Mar. 2010).

[2] This report is one component of the *Independent Auditor's Report on the U.S. Department of State 2010 and 2009 Financial Statements* (AUD/FM-11-03, Nov. 2010).

- **Insufficient Supporting Documentation for Annuitants –** During the FY 2010 audit, Kearney received adequate supporting documentation to complete audit procedures. Therefore, this issue was closed.

- **Refinement of Actuarial Assumptions –** During FY 2010, the Department implemented several refinements and stated that it plans to consider additional refinements during the next experience study in FY 2014. Therefore, this issue was closed but will be reconsidered during the next experience study.

- **Inability To Assign Trading Partner Codes –** During audit work, Kearney found that the Department had implemented compensating controls related to this issue. Therefore, this issue was closed.

PRIOR YEAR MANAGEMENT LETTER COMMENTS – MODIFIED

Some of the findings identified during the audit of the Department's 2009 financial statements remain open. These findings were updated with information obtained during the audit of the Department's 2010 financial statements.

I. Fund Balance with Treasury

<u>Finding</u>:
Fund Balance with Treasury Reconciliation Process

Agencies are required to promptly reconcile Fund Balance with Treasury (FBWT) information in order to identify and resolve differences between the agency financial records and the Department of the Treasury (Treasury) fund balances. Failure to implement timely and effective reconciliation processes increases the risk of fraud, waste, and mismanagement of funds; affects the Government's ability to effectively monitor budget execution; affects the ability to accurately measure the full cost of Government programs; and may lead to erroneous financial statements. The Department does not have a process to reconcile FBWT at the transaction level in order to identify and clear differences in a timely manner.

Kearney reviewed the FBWT reconciliations performed by the Department. The Department maintains two Cash Reconciliation Reports: the Global Financial Services/Charleston (GFS/C) Cash Reconciliation Report and the Financial Reporting and Analysis (FRA) Cash Reconciliation Report. These reports document final balances for each Treasury Account Fund Symbol (TAFS) for the applicable accounting period. Kearney obtained and reviewed both Cash Reconciliation Reports as of June 30, 2010.

The Department also maintains a Detail Cash Reconciliation Report in GFS/C that documents transaction level activity for each TAFS. The report is a static document that contains reconciled and unreconciled items for the applicable TAFSs and is cumulative for the life of the appropriation. This report, produced by the Department's Cash Reconciliation System (CRS), is used to identify possible differences. According to the Department, the final balances for each

TAFS in the Detail Cash Reconciliation Report should agree with the applicable TAFS balances in the GFS/C Cash Reconciliation Report for each accounting period.

Kearney selected 35 Detail Cash Reconciliation Reports for testing purposes. Tests identified differences between the ending balances in the Detail Cash Reconciliation Report and the ending balances in the GFS/C Cash Reconciliation Report for 17 of 35 TAFSs selected for testing. These differences combined for a total net difference of $884,056,000. For all TAFSs, the total difference between the Detail Cash Reconciliation Report and the GFS/C Cash Reconciliation Report was $5,781,000. The smaller unreconciled difference at the total population level indicates that there are similar differences in value in the opposite direction for the untested TAFSs.

Additionally, Kearney identified differences in the ending balances between the Detail Cash Reconciliation Report and the FRA Cash Reconciliation Report for 21 of 35 TAFSs selected for testing. These differences totaled $890,369,000. As a result of the changes made by GFS/C and FRA to clear differences between the GFS/C and FRA Cash Reconciliation Reports, Kearney identified 12 TAFSs that had been adjusted, with a total difference of $6,313,000.

The Department does not reconcile FBWT at the transaction level and investigate individual differences timely. Instead, the Department monitors the difference from Treasury for reasonableness. In addition, the Department does not have a complete transactional history to compare to Treasury because data from the previous financial system was not available to the staff performing the reconciliation. These data restrictions continue to prevent the Department from fully reconciling the FBWT account.

The GFS/C Cash Reconciliation Report is used by the Reports and Reconciliation Team in Charleston, South Carolina, to compare balances recorded by Treasury with balances reported in the Department's general ledger and Global Financial Management System (GFMS) for each TAFS. The GFS/C Cash Reconciliation Report identifies preliminary differences between GFMS and Treasury and is used to create journal vouchers to clear those differences from GFMS. The FRA Cash Reconciliation Report is used by the FRA Branch in Washington, D.C., to compare balances recorded by Treasury with balances reported in the Department's general ledger and GFMS for each TAFS. Differences between these two reports exist in cases where reconciling items have been identified and manual adjustments have been made. The Reports and Reconciliation Team in Charleston identifies necessary changes and submits these adjustments to FRA. In addition, FRA may identify additional changes to be manually adjusted. The timing and identification of these adjustments are the causes of differences in the GFS/C Cash Reconciliation Report and the FRA Cash Reconciliation Report.

Additionally, the Detail Cash Reconciliation Reports may not include detailed Cash Reconciliation System data because the system is not capable of providing detail transactions. Although GFS/C is working to resolve old variances and the dollar amounts may change, these variances continue to exist, and balances remain unreconciled.

Failure to implement timely and effective reconciliation processes could

- Increase the risk of fraud, waste, and mismanagement of funds.
- Affect the Government's ability to effectively monitor budget execution.
- Affect the ability to accurately measure the full cost of the Government's programs.
- Result in violations of the Antideficiency Act.
- Result in erroneous financial statements.

Recommendation:

Kearney recommends that the Department take the following actions:

- Enhance its procedures over the FBWT reconciliation process, including developing procedures to ensure that reconciling items are researched and cleared in a timely manner.
- Improve communication between GFS/C and FRA to ensure reconciling items are cleared in a timely manner and that Cash Reconciliation reports are consistent.
- Complete a thorough review to identify older reconciling items and take actions to clear these items from the monthly reconciliations.

II. Payroll

Finding:

Improper and Untimely Approvals of Personnel Actions and Leave

Effective personnel policies and procedures help ensure that existing employees are compensated only for actual hours worked and benefits earned. Ineffective policies could result in improper payments to ineligible employees or in wages and benefits not being earned or being calculated inaccurately. *The Guide to Processing Personnel Actions*, issued by the Office of Personnel Management (OPM), requires that all Standard Forms (SF) 50, Notification of Personnel Action, be approved before their effective dates. Additionally, the policy requires that all time and attendance (T&A) reports and leave requests be approved by a supervisor before they are submitted to the main timekeeper. If SFs 50 are not being approved properly and timely, personnel actions may be processed late or retroactively, which would lead to more supplemental payments to employees and inaccurate payroll information as of a single pay period.

All Department employees who are U.S. direct hires report their T&A in the Consolidated American Payroll Processing System. Kearney selected a sample of 223 employees to test controls over T&A, personnel actions, and hiring. Sensitive payments were included as part of the personnel actions tests. Sensitive payment areas encompass a range of executive functions, including executive compensation, travel, and perquisites.

For each of the sample items selected, Kearney reviewed the SF 50 for proper and timely approvals. Additionally, for the sample items selected for T&A testing, Kearney reviewed timesheets for proper approval and accurate processing. As a result of the testing, Kearney noted instances of improper and untimely approvals, as shown in Table 1.

Table 1. Improper and Untimely Approvals

Testing Area	Number of Items Tested	Improper and Untimely Approvals
General T&A	133	9
Sensitive Payments	45	39
New Hire Personnel Actions	45	37

Source: Kearney analysis of the approval for personnel actions and leave.

The Department does not have a consistent procedure to process and approve SFs 50 at the bureau level. Specifically, some bureaus have the authority to process and approve SFs 50 while other bureaus do not. The Department has not clearly defined accountability and responsibility for the different procedures. In addition, the Department does not have a centralized monitoring procedure to ensure that forms are processed and approved timely. In some cases, offices may not have a sufficient number of personnel to ensure the segregation of duties or to provide timely approval of payroll documentation.

An organization should ensure that employees are compensated only for actual hours worked and benefits earned. Although Kearney did not find that any of the employees it tested were paid incorrectly, the lack of proper review by responsible personnel may result in incorrect employee pay and benefits and inaccurate leave balances. These errors in payroll could go undetected for long periods of time, which would increase the effort required for correction. In addition, if SFs 50 are not approved properly and timely, personnel actions may be processed late or retroactively, which could lead to supplemental payments being made.

Recommendation:

Kearney recommends that the Department clearly define policies, procedures, and responsibilities for processing and approving employees' personnel and payroll records and develop centralized monitoring procedures, including periodic reviews of documentation, to ensure that bureaus are complying with procedures for processing and approving personnel and payroll records.

Finding:

Improper and Untimely Processing of Employee Separations

Effective personnel policies and procedures help ensure that existing employees are compensated only for actual hours worked and benefits earned. Ineffective policies and procedures could result in improper payments to ineligible employees or in wages and benefits not being earned or being calculated incorrectly. The Department requires that a separated employee be removed from the applicable pay systems in the pay period following the effective date on the SF 50 for his or her separation. If this policy is not followed, employees could remain in the pay system and be paid inappropriately after their effective separation date.

Kearney tested 45 employee separations from the current year to determine whether the employees were removed from payroll, time and attendance, and personnel systems timely. Kearney also verified that the respective SFs 50 were approved before the proposed separation effective date. Kearney noted the following instances of untimely deactivation and approvals:

- Twenty-four personnel records were not deactivated in the personnel system in the pay period following the SF 50 effective date.
- One employee personnel record was made inactive in the personnel system prior to the SF 50 effective date.
- Thirty-two SFs 50 were approved after the proposed separation effective date.

Each bureau and post has been delegated the authority to approve employee separations and enter the information into the personnel system. Kearney found that the bureaus and posts were processing employee separation personnel actions inconsistently. The Department does not have a centralized process to ensure that bureaus and posts are approving employee separations and entering the information into the personnel system in a timely manner.

An organization should ensure that existing employees are compensated only for actual hours worked and benefits earned. Although Kearney did not find that any of the employees it tested were paid incorrectly after their separation dates, the potential for overpayment exists if the employee separation actions are not processed timely. In addition, the lack of proper oversight of personnel actions may result in errors remaining undetected and being uncorrected for long periods of time.

Recommendation:

Kearney recommends that the Department develop centralized monitoring procedures, including periodic reviews of employee separation documentation, to ensure that bureaus and posts are complying with Department policies on employee separations.

Finding:
Insufficient, Inconsistent, or Incorrect Personnel Record Documentation

OPM requires agencies, including the Department, to maintain up-to-date, complete, and correct personnel records for each employee. These personnel folders should include all benefit election forms, as well as any elections resulting in deductions to an employee's pay. Reviewing time and attendance submissions for accuracy and maintaining up-to-date personnel folders help to ensure that employees are compensated only for actual hours worked and benefits earned. Ineffective maintenance of employee personnel folders could result in improper payments to ineligible employees or in wages and benefits not being earned or being calculated incorrectly.

In order to verify the accuracy of employee salaries and benefits, Kearney assessed the completeness of personnel records for a sample of 78 employees. Kearney noted the following discrepancies during testing:

- Forty instances in which the employee's timesheet was not provided.
- Nine instances in which the documentation was not approved by the appropriate officials.
- Fifteen instances in which support showing the authorization for leave taken was not provided.
- Four instances in which leave was not authorized prior to being used.
- Nine instances in which the election on the Federal Employees' Group Life Insurance (FEGLI) Life Insurance Election Form (SF 2817) was not the same as the election on the employee's SF 50.
- Eight instances in which the Federal Employees Health Benefits (FEHB) election selected on the Health Benefits Election Form (SF 2809) did not agree with the election on the employee's Earnings and Leave Statement (ELS).
- Four instances in which the Thrift Savings Plan (TSP) election selected on the Thrift Savings Plan Election Form did not agree with information on the ELS.
- Twenty instances in which various supporting documents were not provided to complete testing. The missing documents included items related to the Flexible Spending Accounts HealthCare/Dependent Care program, state and Federal tax withholdings, Combined Federal Campaign contributions, Immediate Benefits Plans, and dental/vision health benefit forms.

Kearney chose an additional 35 employees for testing to assist OPM with its financial statement audit. Kearney noted the following discrepancies during that testing:

- Two instances in which the SF 2817 did not support the employee's waived/canceled life insurance coverage.
- Three instances in which the FEHB election on the SF 2809 did not match the election code in the payroll system.
- Six instances in which the SF 2817 was not provided.
- One instance in which an employee had waived FEGLI benefits on the SF 2817 but had withholdings for FEGLI from his or her pay.
- One instance in which Basic FEGLI Elections on the SF 2817 did not match information on the SF 50.
- Four instances in which Optional FEGLI Elections on the SF 2817 did not match information on the SF 50.
- One instance in which the Basic FEGLI Election on the SF 2817 did not match information on the SF 50 because the employee had waived Basic FEGLI coverage.
- One instance in which the Optional FEGLI Election on the SF 2817 did not match information on the SF 50 because the employee had waived Optional FEGLI coverage.

The Department did not sufficiently oversee and review the documentation maintained in personnel files, including time and attendance reports. Poor administrative control over the payroll cycle and lack of sufficient and updated supporting documentation in the Official Personnel File may lead to errors in employee pay, improper benefit elections, or increased benefit costs. Incomplete personnel records prevent the timely receipt of sufficient and accurate documentation when requested and hinder the prompt identification and remediation of errors.

Recommendation:

Kearney recommends that the Department strengthen its controls over the review of personnel records by conducting periodic reviews, instituting mandatory training sessions, and increasing accountability for employees who process personnel actions at the bureau level.

MANAGEMENT LETTER COMMENTS – NEW

During the audit of the Department's 2010 financial statements, some additional matters came to Kearney's attention that had not been reported in the prior management letter.

III. General Issue

Finding:
Documentation Not Provided in a Timely Manner

In order to facilitate an efficient and effective audit of the financial statements, the Department needs to provide information in a timely manner. Not providing documentation as requested results in delays to audit testing procedures and difficulties in achieving audit milestones. Meeting the due dates for documentation that are established by the auditor will lead to a more efficient and effective audit, which may create cost savings.

As part of the financial statement audit, Kearney requested data and documentation in order to validate and substantiate account balances and transactions that support the Department's financial statements. In general, the data Kearney requested should be an integral component of the Department's internal control structure and therefore should have been readily available. A summary of audit documentation requested and the length of time that the requests were overdue is presented in Table 2.

Table 2. Response Times for Audit Requests

	Received by Due Date	Received One Week or Less After Due Date	Received Between One and Two Weeks After Due Date	Received Between Two and Three Weeks After Due Date	Received More Than Three Weeks After Due Date
Audit Requests	252 (34%)	294 (39%)	73 (10%)	43 (6%)	83 (11%)

Source: Kearney analysis of response time for items included on the list of audit requests.

Kearney found that delays in providing documentation may have been caused by a number of factors. For instance, Kearney noted that the Department sometimes had difficulties in obtaining information timely from overseas posts. Kearney also noted instances where the Department did not fully understand a request for information but did not request clarification. Sometimes the

Department spent time and effort in obtaining information that was not needed. If the Department had consulted with Kearney on items that it did not understand, a more efficient manner of collecting information could have been identified.

During the year, the Department implemented a new quality control review process. Kearney noted instances where the flow of data was delayed because of the centralized review of every request for data. Certain review efforts appeared to be duplicative, such as reviews of requests related to information technology audit steps, as those requests were previously subjected to a separate liaison and review process. Also, the review process seemed to be universally applied to all requested items, including actual source documents that were not subjective in nature and could not be edited or altered. Additionally, the Department's records management practices were not standardized to properly store and maintain information for management review.

The inability to produce documentation supporting financial transactions can lengthen processing times for analyses and reconciliations as well as increase the possibility of undetected errors. This situation may also be indicative of inaccurate or incomplete information. Delays in providing accurate financial information can lengthen financial reporting cycle times, which decrease the relevance of financial information to end users. Providing timely and accurate information to the auditors could potentially lead to cost savings in performing the financial statement audit.

Recommendation

Kearney recommends that the Department take the following actions:

- Enhance its procedures to ensure that information is provided to the financial statement auditor in a timely manner.
- Streamline the quality review process to ensure that review efforts are not duplicative and are judgmentally applied to relevant items, such as subjective analysis.
- Encourage more direct access for certain information requests and for Department personnel performing specific functions.
- Ensure that standards for records management and retention are in place and enforced.
- Proactively seek clarity on any unclear audit requests in order to facilitate the most efficient and effective means of gathering required documentation.

IV. Accounts Receivable

Finding:
Procedures for Tracking and Reporting Value Added Tax Receivable Need Improvement

The Department operates in over 172 countries, using more than 150 types of currency. Many foreign governments assess a value added tax (VAT) on the goods and services purchased by the Department's missions. Depending on the specific country and type of purchase, the Department may periodically request full or partial reimbursement for VAT payments. Overseas posts are responsible for tracking refundable VAT payments and timely submission of reimbursement requests to local governments. Without adequate procedures to track and report VAT receivables, the Department may not receive timely and complete reimbursement of VAT, and its financial statements could therefore be misstated.

Because of the lack of transaction-specific data, such as a VAT receivable aging report, the Department uses a quarterly estimation process to record a VAT receivable for financial reporting purposes. The estimate is based on disbursement data against overseas allotments where refundable VAT payments are made. The Department performs a calculation based on the average collection rates of refundable VAT payments in eligible countries. Each quarter, the Department records a receivable for the estimated amount using a journal voucher adjustment.

Kearney examined the quarterly VAT receivable adjustment calculated by the Department as of March 31, 2010, and some related supporting documentation. However, the Department was unable to provide documentation to explain the reporting parameters used or the estimation assumptions.

The Department's overseas financial management system does not effectively and efficiently record and track VAT reimbursements. Each post is responsible for developing procedures to accurately track and record receivables in a timely manner. During its FY 2010 site visits, Kearney noted that overseas posts use different manual processes to track refundable VAT payments and submit requests for reimbursement. These manual processes involve the use of spreadsheets and databases outside the Department's accounting system.

The Department's policies do not provide sufficient guidance on tracking VAT reimbursements at posts. While the Department has a documented procedure for preparing the VAT receivable adjustment for the financial statements, it does not have documented procedures relating to the methodology used to set report parameters for the receivable estimation methodology.

The Department's use of accounting estimates without documented procedures, parameters, and assumptions increases the risk of inaccuracies in the financial statements. Nonstandardized manual efforts to track and collect refundable VAT payments at overseas posts increase the risk that the Department will not receive timely and complete reimbursements.

<u>Recommendation</u>:

Kearney recommends that the Department develop policies, procedures, and system enhancements to facilitate consistent tracking and collection of refundable VAT payments. If the Department continues to report value added taxes based on an estimation technique, Kearney recommends that the Department document its procedures related to the estimation methodology. The Department's procedures should be specific enough to allow another group to re-perform the calculations and arrive at the same conclusions.

V. Property and Equipment

Finding:
Incomplete and Inaccurate Heritage Asset Disclosure

Heritage assets represent unique property with historical, cultural, or architectural significance. The Department has heritage assets that are held for public exhibition, education, and official function, including collections of artwork, furnishings, books, and real property. Federal accounting standards require agencies to compile and report information related to heritage assets, such as a description of the heritage asset categories, the number of physical units related to each category, and a general assessment of the condition of the assets. The Department is entrusted with and accountable for this stewardship property. Failure to maintain a complete and accurate list of these assets may result in inaccurate or incomplete financial statements. In addition, the Department may be unable to demonstrate its accountability over the property.

Overseas, each of the Department's posts is responsible for identifying heritage assets and completing an annual physical inventory. Posts are also responsible for maintaining accurate inventory information in the applicable personal property accountability system: either the Integrated Logistics Management System (ILMS) or the Web-based Non-expendable Property Application (WebNEPA). GFMS property records are periodically updated with the data that is entered into the property accountability systems by post personnel.

During FY 2010, the Department centralized certain responsibilities over the identification and reporting of heritage assets to domestic positions. In addition, the Department is in the process of converting posts from WebNEPA to ILMS. As part of these initiatives, the Department was reconciling heritage asset information between WebNEPA, GFMS, hard-copy documentation of art work appraisals performed at posts in prior years, and the actual inventory provided by posts. After completing the reconciliation, the Department found that heritage asset information for many posts was incomplete and inaccurate. For instance, during FY 2010, the Department increased the number of items reported for the cultural heritage asset collection by approximately 2,000 items.

Kearney attempted to reconcile the heritage asset information from the property accountability systems (ILMS and WebNEPA) with the Department's heritage asset financial statement note disclosure for a randomly selected sample of 10 posts. Kearney noted 296 discrepancies during a reconciliation of heritage asset information for the 10 posts sampled.

As of September 30, 2010, approximately 40 percent of the Department's posts had not been converted to ILMS and therefore had not undergone a full reconciliation of their heritage asset inventory. In addition, effective policies and procedures related to heritage asset inventory management and reporting had not been effectively communicated to and implemented by all overseas posts. During its FY 2010 post visits, Kearney noted an inconsistent understanding of what constitutes a heritage asset and varying levels of awareness of the responsibility for heritage assets. Kearney also found that the Department had not formalized the assignment of responsibilities to the newly formed domestic office responsible for heritage assets.

Until the system conversion and reconciliation process is substantially complete, heritage asset item counts reported in the Department's financial statement note disclosure will be incomplete and inaccurate. Although the costs of the assets are not reported in the financial statements, the reported heritage asset information is important for users to understand the operations and financial condition of the Department. Without an accurate inventory of the heritage assets, the Department is unable to demonstrate the long-term benefit of these assets to the public or to show that it is sufficiently responsible and accountable for these assets. In addition, the Department is unable to determine the condition of the unreported assets and ensure that it provides protection and preservation services to maintain the heritage assets.

Recommendation:

Kearney recommends that the Department take the following actions:

- Continue its reconciliation of heritage asset information during the post conversions to the Integrated Logistics Management System.
- Improve the communication and implementation of policies and procedures regarding the management of heritage asset inventories.
- Formalize and communicate the assignment of responsibilities between overseas posts and domestic bureaus.
- Provide additional training and policy refinement to ensure the consistent determination of heritage assets.

VI. Accounts Payable

Finding:
Improvements Needed in the Acquisition and Vendor Payment Process

Effective acquisition and vendor payment policies and procedures help ensure that disbursements are made only for goods and services related to an agency's mission and that have been received and recorded in accordance with Federal accounting standards. Ineffective execution of acquisition and vendor payment policies and procedures could result in improper payments for goods or services that were not received or were not in compliance with specifications, as well as inaccurate financial records.

Agencies obtain goods and services from vendors as part of normal business operations. Elements of the acquisition and payment process include ensuring that the goods or services were actually received and accepted, payments were supported by adequate documentation, and payments were properly certified prior to disbursement.

The receipt of goods or services from the vendor is a critical point in the acquisition and payment cycle. An agency should identify employees who are authorized to receive and accept the goods or services, and those employees should document that the goods or services were received in a timely manner and complied with requirements. Kearney found that the Department did not maintain a listing of designated receiving officers who are authorized to receive and accept goods and services for the Department. Of a sample of 306 transactions, Kearney also found 11 instances in which the Department did not have a proper receiving report, which would have documented the name and signature of a Department representative who was authorized to receive and accept goods and services.

Other critical points in the acquisition and payment cycle are the processing and recording of the vendor payment, which would include properly certifying the accuracy of information contained in the voucher and supporting documents and maintaining adequate documentation to support the payment. Of a sample of 43 non-routine transactions, the Department was unable to substantiate the certification of one payment. In addition, for 71 transactions, the Department was unable to provide adequate documentation to support the validity of the amount owed or paid. Kearney also found 80 invoices submitted for payment that were not dated upon receipt or did not include a fax server verification, which is used for electronic submission of vendor invoices to facilitate payment in order to reduce the physical distribution of paper invoices and accompanying paper documentation. Because the invoices were not dated when received, Kearney either was unable to confirm timeliness of payments or based its decision on the timeliness of the payment on the invoice date included by the vendor.

The Department did not have an adequate process in place to ensure that its employees were complying with policies and procedures related to documenting that goods or services were received and payments were properly certified. In addition, vendor invoices were not stamped or annotated as having been received, and proper receiving documentation was not created or maintained to confirm that individuals who received and accepted goods or service were authorized to do so. Additionally, the Department's records management practices were not standardized to properly store and maintain information for management review.

Limited adherence to procedures for receiving goods or services from a vendor and for overseeing the vendor payment process increases the likelihood that improper payments could be made or waste, fraud, and abuse could occur and go undetected. Ineffective oversight could create circumstances in which goods and services are acquired that are not needed or payment is made for goods and services not received. In addition, without adequate documentation, the Department cannot ensure that invoices are paid accurately, and it would be unable to efficiently monitor vendor payments or research issues related to the payments.

Kearney found that the Department did not have proper receiving documentation to support payments of approximately $4 million and did not provide sufficient supporting documentation to confirm the validity of nearly $31 million in amounts owed and/or payments made. Additionally, the Department was unable to provide supporting documentation for the certification of a $22 million payment.

<u>Recommendation</u>:

Kearney recommends that the Department strengthen controls to ensure that the receipt of goods and services is documented and vendor payments are processed and recorded properly. Specifically, the Department should

- Develop and implement a process to monitor the execution of its policies and procedures, particularly related to invoice processing.
- Reemphasize to all personnel with invoice processing responsibilities the importance of complying with Department policies.
- Fully develop, document, and enforce records management and retention policies for all current and future disbursement transactions, including standardizing procedures to ensure that documentation files are sufficient to constitute a complete history of the transaction and provide a complete audit trail.

VII. Budgetary Resources

Finding:

Untimely Reconciliation of Budgetary and Proprietary Accounts

Federal financial accounting standards require an entity to be able to reconcile its proprietary information with budgetary information. Based on best practices, this would be most efficiently accomplished by using a fully integrated accounting system that simultaneously records both the proprietary and budgetary impact of an accounting event at the transaction level.

The Department does not have a fully interfaced budgetary and proprietary financial reporting system, and it relies on a manual year-end process in order to adjust its budgetary accounts and create the Reports on Budget Execution and Budgetary Resources (SF 133) and the Statement of Budgetary Resources. The significant reliance on manual adjustments during interim and year-end reporting increases the risk for errors that may not be caught in time for correction. Reconciling the proprietary information with the budgetary information would reduce the risk for errors. However, the Department has been unable to produce a timely reconciliation of the budgetary accounts with the proprietary accounts.

The Department does not ensure that effective fund reconciliations are performed at the transaction level in a timely manner throughout the fiscal year. As a result, the Department processes a substantial number of manual adjustments as part of its year-end financial reporting process. The adjustments are needed to ensure that the data in the Department's financial management system reconciles with data from the Governmentwide Accounting (GWA) System. These adjustments are designed to correct invalid entries or inaccuracies in posting to fund symbols for fund activities processed during the year.

During the review of the interim reconciliation of budgetary information with proprietary information prepared by the Bureau of Resource Management (RM), Kearney noted that the reconciliation was incomplete and included unreconciled differences. The Department was unable to identify the cause of these differences. RM had limited the reconciliation of budgetary and proprietary information with line items on the Statement of Budgetary Resources, which is a very high level.

Additionally, Kearney noted the year-end reconciliation of budgetary information with proprietary information was not provided by RM in a timely manner. RM provided the final reconciliation almost 4 weeks later than the originally requested due date of October 17, 2010. The final reconciliation did not contain any material reconciling items.

The Department does not have a fully interfaced budgetary and proprietary financial reporting system. To compensate for this deficiency, the Department relies on a manual process to adjust budgetary accounts. Specifically, the Department has designed Excel workbooks, which are used to create the SFs 133, which are in turn used to develop the Statement of Budgetary Resources. The workbooks were designed to ensure agreement of certain line items with external Treasury reports. The Department uses the information in the workbooks to identify necessary adjustments between the information, which would then be manually corrected on a fund-by-fund basis. The workbooks are prepared manually and require multiple iterations of manual adjustments and workbook versions for each individual TAFS.

As part of the reconciliation, the Department adjusts FBWT to ensure agreement with Treasury-reported amounts from the GWA System. The Department must then adjust the related budgetary accounts to ensure their agreement with the revised FBWT amount. Because of the Department's lack of a regular process to reconcile budgetary information with proprietary information, additional procedures must be performed to validate that the Statement of Budgetary Resources is in alignment with the proprietary financial statements.

Kearney also found that the Federal Agencies Centralized Trial-Balance System II data is not developed from data maintained within the Department's financial accounting system. The posting model logic for accounting entries in the financial system is not designed accurately, causing accounts to be out of balance and creating the need for adjustment prior to the submission of required data to the Treasury.

The Department is unable to reconcile its budgetary account balances with related proprietary accounts in a timely manner. Unreconciled differences or untimely reconciliation of differences are indicative of weak controls over financial accounting and reporting, which may lead to a misstatement of the financial statements if the causes of differences are not able to be identified. Because of the significant manual intervention in the process, potential errors may be created that would not be identified in a timely manner for correction.

<u>Recommendations</u>:

Kearney recommends that the Department take the following actions:

- Reconcile the budgetary and proprietary systems' data monthly, leveraging the Department of the Treasury's Tie-Point Project.
- Reconcile reported data submissions quarterly to support required reporting to the Department of the Treasury and the Office of Management and Budget.
- Review differences and identify contributing fund symbols and possible issues leading to any imbalance.
- Develop more effective communication between key personnel to ensure the timely delivery of all needed information.

- Review standard general ledger models for reconciling budgetary accounts with proprietary accounts in an effort to capture all appropriate accounts in the reconciliation.
- Integrate the Statement of Budgetary Resources preparation process into the Hyperion financial reporting system.

ACRONYM LIST

Acronym	Definition
CRS	Cash Reconciliation System
ELS	Earnings and Leave Statement
FBWT	Fund Balance with Treasury
FEGLI	Federal Employees' Group Life Insurance
FEHB	Federal Employees Health Benefits
FRA	Financial Reporting and Analysis
GFMS	Global Financial Management System
GFS/C	Global Financial Services/Charleston
GWA	Governmentwide Accounting
ILMS	Integrated Logistics Management System
OPM	Office of Personnel Management
RM	Bureau of Resource Management
SF	standard form
TAFS	Treasury Account Fund Symbol
Treasury	Department of the Treasury
TSP	Thrift Savings Plan
T&A	time and attendance
VAT	value added tax
WebNEPA	Web-based Non-expendable Property Application

United States Department of State

Chief Financial Officer

Washington, D.C. 20520

UNCLASSIFIED

FEB 17 2011

MEMORANDUM

TO: OIG – Harry W. Geisel

FROM: RM – James L. Millette

SUBJECT: Draft Management Letter Related to the Audit of the Department of State's Fiscal Year (FY) 2010 Financial Statements

This is in response to your request for comments on the Independent Auditor's Draft Management Letter (Letter) related to the audit of the Department of State's (Department) FY 2010 Financial Statements.

The Department concurs in concept with the Letter's recommendations. We believe the Letter identifies areas where processes and internal controls can be strengthened to improve the Department's financial reporting and operations. We will work collaboratively and constructively with your office and Kearney & Company on the recommendations identified in the Letter to implement improvements and address these matters. As we work with Kearney to identify the needed corrective actions, we may propose alternative means to address the spirit of the recommendations versus the specific recommendations proposed in the Letter. We may also identify situations where the cost to implement a specific part of a recommendation may exceed the projected benefit. Regardless, we are committed to build on the progress made over the last year.

We thank you for the opportunity to comment on the draft Letter. We would also like to extend our appreciation to your staff and to Kearney & Company for the professional and collaborative manner in which they conducted the audit. We believe considerable progress on a number of matters was made over the past year as a result of the collaborative manner in which the audit was conducted.

cc: OIG/AUD – Ms. Evelyn Klemstine
Kearney & Company, P.C. – Mr. Jeffrey W. Green
RM/DCFO – Christopher H. Flaggs
RM/EX – Phillip J. Schlatter