United States Department of State
and the Broadcasting Board of Governors

Office of Inspector General

November 15, 2010

INFORMATION MEMO FOR THE SECRETARY

FROM: OIG/DIG – Harold W. Geisel

SUBJECT: Independent Auditor's Report on the U.S. Department of State 2010 and 2009 Financial Statements (AUD/FM-11-03)

An independent certified public accounting firm, Kearney & Company, P.C., was engaged to audit the financial statements of the U.S. Department of State (Department) as of September 30, 2010 and 2009, and for the years then ended, to provide a report on internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations, to report on whether the Department's financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA), and to report any reportable noncompliance with laws and regulations it tested. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; Office of Management and Budget audit guidance; and the *Financial Audit Manual*, issued by the Government Accountability Office and the President's Council on Integrity and Efficiency.

In its audit of the Department, Kearney & Company, P.C., found

- the consolidated balance sheets as of September 30, 2010 and 2009, and the related consolidated statements of net cost and changes in net position for the years then ended, and the related combined statement of budgetary resources for the year ended September 30, 2010, present fairly, in all material respects, the financial position of the Department as of September 30, 2010 and 2009, and its net cost of operations and changes in net position for the years then ended, and its changes in budgetary resources for the year ended September 30, 2010, in conformity with accounting principles generally accepted in the United States of America. Kearney & Company, P.C., was unable to obtain sufficient evidential support for the amounts presented in the 2009 combined statement of budgetary resources and therefore was unable to express an opinion on the 2009 combined statement of budgetary resources;

- no material weaknesses[1] in internal control; and
- instances of reportable noncompliance with laws and regulations tested, including instances in which the Department's financial management systems did not substantially comply with FFMIA.

Kearney & Company, P.C., is responsible for the attached auditor's report, which includes the Report of Independent Auditors, the Report on Internal Control, and the Report on Compliance and Other Matters, dated November 14, 2010, and the conclusions expressed in the report. The Office of Inspector General (OIG) does not express an opinion on the Department's financial statements or conclusions on internal control and compliance with laws and regulations, including whether the Department's financial management systems substantially complied with FFMIA.

Comments on the auditor's report from the Bureau of Resource Management are attached to the report.

OIG appreciates the cooperation extended to it and Kearney & Company, P.C., by Department managers and staff during the conduct of this audit.

Attachments: As stated.

[1] 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.

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REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying consolidated balance sheets of the U.S. Department of State (Department) as of September 30, 2010 and 2009, and the related consolidated statements of net cost and changes in net position and combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as described in the following paragraphs, we conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Department was unable to provide timely and complete competent evidential matter to enable us to perform audit procedures to satisfy ourselves that the combined statement of budgetary resources for the year ended September 30, 2009, was free of material misstatements. Our audit work identified issues related to the systems, processes, and internal controls supporting financial reporting, as well as key account balances. As a result of these limitations, we were unable to obtain sufficient evidential support for the amounts presented in the 2009 combined statement of budgetary resources.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the combined statement of budgetary resources for the year ended September 30, 2009.

In our report dated December 14, 2009, we expressed an opinion that the scope of our work was not sufficient to express an unqualified opinion on the 2009 consolidated balance sheet and statement of changes in net position. We qualified our report based on a scope limitation related to property and equipment. The Department was unable to provide timely and complete competent evidential matter to enable us to perform audit procedures to satisfy ourselves that the property and equipment balance was free of material misstatements. Our work identified issues related to land valuation; identification and valuation of assets and liabilities under capital leases; completeness and accuracy of real property; and existence, completeness, and valuation of personal property. As a result of these limitations, we were unable to obtain sufficient evidential support for property and equipment amounts presented in the 2009 consolidated balance sheet and consolidated statement of net position. As described in Note 20, the Department addressed these issues and restated its 2009 financial statements. Accordingly, our present opinion on the 2009 consolidated balance sheet and consolidated statement of changes in net position, as presented herein, is different from that expressed in our previous report.

In our opinion, the consolidated balance sheets of the Department as of September 30, 2010 and 2009, and the related consolidated statements of net cost and changes in net position for the years then ended, and the combined statement of budgetary resources for the year ended September 30 2010, including the accompanying notes, present fairly, in all material respects, the financial position of the Department as of September 30, 2010 and 2009, and its net cost of operations and changes in net position for the years then ended, and its changes in budgetary resources for the year ended September 30, 2010, in conformity with accounting principles generally accepted in the United States of America.

The Department's Management's Discussion and Analysis, other Required Supplementary Information (including stewardship information), and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements. We do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with the Department. On the basis of this limited work, we found no material inconsistencies with the financial statements, accounting principles generally accepted in the United States of America, or OMB Bulletin No. 07-04, as amended.

In accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have also issued reports, dated November 14, 2010, on our consideration of the Department's internal control over financial reporting and compliance and on our tests of its compliance with certain provisions of laws and regulations for the year ended September 30, 2010. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the Department's compliance with certain provisions of laws and regulations and the results of that testing, and not to provide an opinion on the internal control over financial reporting and compliance or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, and should be considered in assessing the results of our audits.

Kearney & Company

November 14, 2010

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REPORT ON INTERNAL CONTROL

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

We have audited the 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 dated November 14, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. The management of the Department is responsible for establishing, maintaining, and assessing internal control related to financial reporting and compliance.

In planning and performing our work, we considered the Department's internal control over financial reporting and compliance by obtaining an understanding of the design effectiveness of the Department's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of the Department's controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal controls. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting and compliance or on management's assertion on internal control included in Management's Discussion and Analysis.

We limited our internal control testing to those controls necessary to achieve OMB Bulletin No. 07-04 control objectives that provide reasonable, but not absolute assurance, that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in compliance with laws governing the use of budget authority, government-wide policies and laws identified in Appendix E of OMB Bulletin No. 07-04, as amended, and other laws and regulations that could have a direct and material effect on financial statements. We did not test all internal controls relevant to operating objectives, as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to ensuring efficient operations.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraphs and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. 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. We consider the following deficiencies in the Department's internal control to be significant deficiencies.

Significant Deficiencies

I. Financial Reporting

The Department compiles its financial statements through a multi-step process using a combination of manual and automated procedures. Neither the Department's Global Financial Management System nor the "top level" Hyperion reporting system are used to fully compile the statements. The inability of the financial management system to track the necessary attributes related to financial reporting forces the Department to use a manual, labor-intensive process to develop its balance sheet, statement of net cost, and statement of changes in net position. The necessary data is extracted from multiple systems and source files, and is sometimes manually keyed into crosswalk files or statement preparation templates (Excel workbooks), which ultimately create the Department's financial statements. In addition, the Department lacks a budgetary financial reporting system that is integrated with the financial management system general ledger, which forces the Department to use a manual, labor-intensive process to develop its statement of budgetary resources. Manual adjustments require an increased measure of internal control and review, reduce the Department's ability to produce statements timely, and increase the likelihood of errors in the statements.

In our report on the Department's 2009 financial statements, we identified financial reporting as a material weakness. During FY 2010, the Department developed a corrective action plan to address control deficiencies and financial reporting risks surrounding the financial statement preparation process. The plan included performing an analysis of the compilation process with the objective of evaluating the processes used and establishing a plan of action for ensuring the processes were appropriate and efficient. The Department implemented manual compensating controls to reduce financial reporting risk in this area. Compensating controls can limit the severity of the deficiency but do not eliminate the deficiency. Although improvements were made, the preparation of the financial statements outside of the Department's financial systems and the lack of an integrated budgetary and financial process continue to be a significant deficiency in the Department's financial reporting process.

II. Property and Equipment

The Department reported nearly $13 billion in net property and equipment (P&E) on its 2010 balance sheet, about 19 percent of total assets. Based on the pervasiveness of the deficiencies in internal control identified and the related risk of a material misstatement in the financial statements, we assessed the Department's property accounting challenges as a material weakness in our report on the Department's 2009 financial statements. During FY 2010, the Department successfully executed several corrective actions, including:

- A complete reconciliation of real property assets listed in the Department's general ledger to records listed in its property management system.
- Performance of a historical cost revaluation for real properties acquired by gift, which were overstated in prior periods.
- Expansion of lease accounting procedures.

The corrective actions described above identified significant misstatements and resulted in the restatement of 2009 P&E balances. The newly implemented and expanded procedures will reduce the risk of significant misstatements in future periods. However, the Department's internal control structure exhibits several deficiencies that continue to negatively affect the Department's ability to account for real and personal property in a complete, accurate, and timely manner. For 2010, we considered this combination of control deficiencies to be less severe than a material weakness, yet important enough to merit attention by those charged with governance. The individual deficiencies we identified are discussed below.

- <u>Accounting for Construction-in-Progress (CIP)</u> – The Department reported approximately $2.7 billion in domestic and overseas CIP as of September 30, 2010. The Department's internal control structure did not ensure that only valid project costs were capitalized. Transaction-level reviews or other compensating controls did not prevent expenses and personal property amounts from being recorded as CIP. In addition, the internal control structure did not ensure a comprehensive analysis of domestic projects during the assignment of project codes, the accurate recording of contractor retainage, or the identification of lagging costs at the time of a project's substantial completion and transfer into service.

- <u>Accounting for Personal Property</u> – The Department reported over $800 million in net personal property as of September 30, 2010. Audit procedures identified several deficiencies in the Department's internal control structure surrounding personal property. The Department's control structure did not ensure that personal property acquisitions and disposals were recorded timely and accurately. In addition, the audit identified incomplete and inaccurate contractor-held property inventories.

- <u>Accounting for Internal Use Software and Software-in-Development</u> – The Department's method for tracking and recording software costs is based on a manual data call process that is not integrated with the core accounting system. The Department's control structure did not ensure that project status was monitored, or that substantially completed projects were identified. Audit inquiries identified current and prior period misstatements that were not identified by the Department's control structure. These adjustments were recorded as manual journal vouchers during the preparation of the financial statements.

- Capital Leases – The Department manages approximately 7,500 real property leases. Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, requires an analysis of leases for capitalization based on four criteria. Prior to FY 2010, the Department did not apply one of the four SFFAS No. 6 capital lease evaluation criteria due to the lack of fair market value estimates for leased properties. The Department expanded procedures to perform analysis on a subset of leases identified as being potentially capital. However, the internal control structure did not ensure the accurate submission of lease terms by overseas posts, the proper exclusion of land leases from capitalization, or the accurate designation of funded versus unfunded lease liabilities. A comprehensive review of lease agreements had been initiated by the Department but was not complete as of the date of audit testing. In addition, amortization schedules and net present value calculations were manually created and susceptible to error.

III. Accounts Payable Accrual

The Department does not have adequate internal controls in place to ensure that the Federal accounts payable (AP) accrual is reasonably estimated. GAAP requires an agency to estimate the amount of goods and services received before year end for which an invoice was not recorded in the accounting records at year end. The Department designed and implemented a method to calculate the amount owed to other Federal entities. However, The Department did not complete the calculation in time to validate its methodology. The lack of a formal validation limits the Department's ability to ensure that its methodology is consistent with actual events.

Additionally, the Department designed and implemented new methods to calculate and validate the domestic and overseas AP accruals during FY 2010. However, management could not provide sufficient evidence to support the validity of the statistical concepts used.

IV. Budgetary Accounting

The Department lacks sufficient reliable funds control over its accounting and business processes to ensure budgetary transactions are properly recorded, monitored, and reported. The individual deficiencies we identified are discussed below.

- Effectiveness of Allotment Controls – The Department's accounting systems have automated controls to prevent posting of obligations that exceed available allotment funding authority; however, these controls were overridden by Department personnel. The audit process identified 691 instances in which the allotment funds control was overridden in a two-month period. Allotments provide authority to incur obligations to agency officials, as long as those obligations are within the scope and terms of the allotment authority. Since the Department does not possess an integrated budgetary financial reporting system, breakdowns in allotment funds controls further strain the manual, labor-intensive process to develop the statement of budgetary resources. Overriding the allotment funds control could lead to a violation of the Antideficiency Act and increases the risk of fraud, misuse, and waste.

- Delegated Contracting Authority – The Department does not have a process to ensure that contracting officers adhere to the approved contracting authority delegated by the Department. Execution of binding agreements above contracting limits is a violation of procurement or appropriation law and increases the risk that invalid transactions to commit resources may be recorded. The audit process identified 29 instances in which 13 different contracting officers exceeded their delegated authority. We noted $674 million in obligations related to Department agreements that may represent unauthorized, non-binding agreements.

- Validity and Accuracy of Unliquidated Obligations – The Department's internal controls are not sufficient to ensure that unliquidated obligations (ULO) are consistently and systematically evaluated for validity and deobligation. Weaknesses in controls over ULOs were initially reported in the audit of the Department's 1997 financial statements and subsequent audits. ULOs represent the cumulative amount of orders, contracts, and other binding agreements not yet outlayed. The Department's policies and procedures provide guidance related to the periodic review, analysis, and validation of the ULO balances posted to the general ledger. The current internal control structure is not operating effectively to comply with existing policy or facilitate the accurate reporting of ULO balances recorded in the financial statements. The current process is not systematically and timely identifying open obligations that require deobligation. The audit process identified adjustments outside of the operation of the internal control structure of approximately $118 million related to ULOs that required deobligation. The Department recorded this audit adjustment in the financial statements.

- Unsupported Obligations – The Department's financial management system is designed to reject payments for invoices without established obligations. Because allotment holders are not always recording valid and accurate obligations prior to the receipt of goods and/or services, the Department establishes low-value obligations to bypass system internal controls, allowing invoices to be paid in compliance with the Prompt Payment Act. The audit process identified 1,285 low-value obligations for which the Department could not provide evidence of a binding agreement to support these obligations. The Department should record obligations based upon a reasonable estimate of the Department's potential liability. The continued use of this practice could lead to a violation of the Antideficiency Act and increase the risk of fraud, misuse, and waste.

- Timeliness and Accuracy of Obligations – Procedures and controls are not adequate to ensure the accurate and timely creation, approval, and recording of obligations. During our testing, we noted obligations that were not recorded within 30 days of execution of the obligating document; in some cases, the obligation was posted subsequent to the receipt of goods and services by the Department. We also detected obligations that did not have adequate funds available at the time the expenditure was processed. Additionally, we noted that management did not have a sufficient process in place to ensure proper cutoff of obligations at year end.

V. Liability to International Organizations

The Department does not have adequate internal controls in place to ensure the amount recorded as a liability to international organizations is complete and accurate. GAAP requires a liability to be recorded at year end for obligations due but not yet paid. The Department does not have policies and standardized procedures in place to track and evaluate international agreements, and determine the need to record a liability in the financial statements. The Department currently maintains a schedule of liabilities to international organizations; however, it does not represent, nor was it designed to represent, all international organizations that may result in a liability. The liabilities tracked on the Department's schedule are based on assessments received, or are expected to be received, and not yet paid. The accrual of the liability at year end is based on a manual review of that listing. The manual review is susceptible to error and increases the risk that organizations warranting accrual will not be identified, or that previously recorded liabilities that are no longer intended to be paid will not be removed.

VI. Information Technology

The Department's information technology (IT) internal control structure, both for the general support systems and critical financial reporting applications, did not include a comprehensive risk analysis, effective monitoring of design and performance, and an ability to identify and respond to changing risk profiles. The National Institute of Standards and Technology and Government Accountability Office (GAO), in its Federal Information System Controls Audit Manual, provide control objectives and evaluation techniques utilized during the course of our audit.

IT controls were reported as a significant deficiency in our report related to the Department's 2009 financial statements. In FY 2010, the Department remediated certain deficiencies, including documenting controls in multiple applications, improving definitions of user roles and responsibilities, and reducing instances of inadequate segregation of duties. However, the Department's IT control environment included design and operation weaknesses that, when combined, are considered to be a significant deficiency, as summarized below.

- The Department has not completed a segregation of duties analysis of user rights and authorizations, or appropriately assigned rights in several systems. In addition, the Department could not demonstrate that system owners annually validated user privileges in four applications. Failure to maintain risk profiles and validate user roles may result in inadequate segregation of duties, a weakening of the control environment, errors, and irregularities.

- The Department was unable to provide current hardware and software configuration baselines for 11 significant applications that process the majority of financial transactions. The baselines are necessary to plan, approve, and implement configuration changes. The baselines facilitate assessing security risks, defining security assessments, performing vulnerability scans, and monitoring performance of control configurations. The baselines also support effective and efficient recovery of systems.

- The Department could not provide documentation and analysis of automated controls in four critical financial applications. These automated controls related to data entry validation, management approvals, segregation of duties, and edit controls. The Department could not provide documentation of data validation controls in another application. Without this information, the Department could not effectively validate controls against the original design supporting accuracy, completeness, validity, and authenticity, which could potentially result in financial reporting errors, improper payments, waste, fraud, and abuse.

- The Department does not cancel system access for separated or inactive users timely. We identified 23 separated employees who had active accounts in two critical applications, and another application contained 36 users whose accounts were inactive for over 90 days. Inactive or terminated user accounts may facilitate circumvention of internal controls, potentially resulting in erroneous and improper transactions, embezzlement, unauthorized use, and a weakening of the internal control structure.

- The Department does not require or could not provide management's approval of system software changes in two critical applications. Management's review and approval helps prevent software changes that are unnecessary, cause processing conflicts, inadequately address user needs, or weaken the internal control structure. The reviews may also help identify changes that will cause errors once placed in production.

During the audit, we noted certain other matters that we will report to Department management in a separate letter. Additionally, Department management has indicated in a separate response that it concurs with the findings presented in our report. We did not audit the Department's response, and accordingly, we express no opinion on it.

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STATUS OF PRIOR YEAR FINDINGS

In the Report on Internal Control included in the audit report on the Department's 2009 financial statements,[1] several issues were noted related to internal control over financial reporting. The table below presents a summary of our internal control findings.

Prior Year Significant Internal Control Deficiencies

Control Deficiency	2009 Status	2010 Status
Environmental Liability Restatement	Material Weakness	Management Letter
Financial Reporting	Material Weakness	Significant Deficiency
Property and Equipment	Material Weakness	Significant Deficiency
Accounts Payable Accruals	Significant Deficiency	Significant Deficiency
Validity and Accuracy of ULOs	Significant Deficiency	Combined with Budgetary Accounting
Information Technology	Significant Deficiency	Significant Deficiency

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This report 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, OMB, GAO, Department of the Treasury, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Kearney & Company

November 14, 2010

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

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REPORT ON COMPLIANCE AND OTHER MATTERS

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

We have audited the 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 dated November 14, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. The management of the Department is responsible for compliance with laws and regulations.

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04, as amended. As part of our work, we performed tests of compliance with the Federal Financial Management Improvement Act (FFMIA), Section 803(a) requirements. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. Providing an opinion on compliance with certain provisions was not an objective of our audit and accordingly, we do not express such an opinion.

The results of our testing disclosed instances of noncompliance or other matters exclusive of FFMIA that are required to be reported under *Government Auditing Standards* and the requirements of OMB Bulletin No. 07-04, as amended, and which are summarized in the following paragraphs:

- *Antideficiency Act*. This act prohibits the Department from (1) making or authorizing an expenditure from, or creating or authorizing an obligation under, any appropriation or fund in excess of the amount available in the appropriation or fund unless authorized by law; (2) involving the Government in any obligation to pay money before funds have been appropriated for that purpose, unless otherwise allowed by law; and (3) making obligations or expenditures in excess of an apportionment or reapportionment, or in excess of the amount permitted by agency regulations. Our audit procedures identified Department of the Treasury (Treasury) fund symbols with negative balances potentially in violation of the Antideficiency Act.

- *Chief Financial Officers Act of 1990*. This act requires the development and maintenance of an integrated accounting and financial management system that (1) complies with applicable accounting principles, standards and requirements, and internal control standards; (2) complies with such policies and requirements as may be prescribed by the Director of OMB; (3) complies with any other requirements applicable to such systems; and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and is responsive to the financial information needs of agency management; (ii) the development and reporting of cost information; (iii) the integration of accounting and budgeting information; and (iv) the systematic measurement of performance. However, we found that the Department's financial system does not fully integrate accounting and budgetary information.

- *OMB Circular A-127, Financial Management Systems.* This circular requires the Department to establish and maintain an accounting system that provides for (1) complete disclosure of the financial results of the activities of the Department; (2) adequate financial information for Department management, and for formulation and execution of the budget; and (3) effective control over revenue, expenditure, funds, property, and other assets. However, we found that the financial system did not maintain effective control over property, budgetary accounting, and financial reporting.

- *Budget and Accounting Procedures Act of 1950.* This act requires an accounting system to provide full disclosure of the results of financial operations, adequate financial information needed in the management of operations and the formulation and execution of the budget, and effective control over income, expenditures, funds, property, and other assets. The Department lacks a budgetary financial reporting system that is integrated with the financial management system general ledger, which forces the Department to use a manual, labor-intensive process to develop the statement of budgetary resources. In addition, we found that the Department's financial system does not provide effective control over property and unliquidated obligations.

- *Prompt Payment Act of 1982.* This act requires Federal agencies to make payments in a timely manner, pay interest penalties when payments are late, and take discounts only when payments are made within the discount period. Audit procedures identified multiple instances in which the Department had incorrectly calculated interest penalties on overdue payments. Additionally, we found that the Department did not consistently pay interest penalties for overseas payments that were not paid in accordance with the Prompt Payment Act.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger (USSGL) at the transaction level. We noted certain instances, described below, in which the Department's financial management systems did not substantially comply with certain Federal system requirements, Federal accounting standards, and the USSGL at the transaction level.

Federal Financial Management Systems Requirements:

- A reconciliation of budgetary and proprietary accounts was not part of the Department's routine control structure and could not be provided in a timely manner.
- Appropriation and transfer balances reported in the Department's accounting system did not always reconcile to data reported by Treasury.
- Certain subsidiary systems, including property systems, were not integrated with the core accounting system. An audit trail from data in the core financial system to detailed source transactions in feeder systems was not always readily available.
- User access and authorization controls were not documented in all cases. Adequate segregation of duties was not maintained in certain financial systems.
- The audit process identified instances in which automated controls to prevent postings of obligations that exceeded available allotment funding authorities were overridden. In addition, transactions were able to be posted to invalid allotment codes.
- Interest on overdue payments was not always calculated correctly on domestic payments and not always paid on overdue overseas payments.

Applicable Federal Accounting Standards:

- The Department's core accounting system did not produce complete, auditable financial statements without significant manual adjustments.

Standard General Ledger at the Transaction Level:

- The Department's statement of budgetary resources was subject to numerous adjustments that were made outside of the core accounting system and that could not be traced directly to USSGL account balances.
- Financial data could not be appropriately and directly matched to financial statements and OMB and Treasury reports from USSGL codes.

Except as noted above, our tests for compliance with the provisions of selected laws and regulations disclosed no other instances of noncompliance that would be reportable under the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended.

During the audit, we noted certain other matters that we will report to Department management in a separate letter. Additionally, Department management provided a separate response to our report. We did not audit the Department's response, and accordingly, we express no opinion on it.

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KEARNEY& COMPANY

This report 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, OMB, GAO, Treasury, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Kearney & Company

November 14, 2010

United States Department of State

Washington, D.C. 20520

November 14, 2010

MEMORANDUM

TO: OIG – Mr. Harry W. Geisel

FROM: RM – Mr. James L. Millette

SUBJECT: Draft Audit Report on the Department of State's 2010 and 2009 Financial Statements

This is in response to your request for comments on the Draft Report of Independent Auditor, Report on Internal Control, and Report on Compliance and Other Matters (Report) of the U.S. Department of State's fiscal year (FY) 2010 and 2009 Financial Statements.

The Department operates in over 260 locations in 172 countries, while conducting business in 150 currencies and an even larger number of languages. Few agencies or corporations have the variety of challenges that the men and women of the Department of State (Department) face daily. Despite these complexities, the Department pursues a commitment to financial integrity, transparency, and accountability that is the equal of any large multi-national corporation. Working closely with your office and the Independent Auditor, Kearney & Company, we are pleased that we were able to achieve an unqualified opinion on our FY 2010 financial statements.

It is a long and exacting march to issue the annual financial statements by November 15. We have worked smarter and with unity of purpose this year to meet the demands and paces of the external audit process in order to demonstrate the strong financial management work that is conducted on a daily basis in the Department. It has been a concerted and dedicated effort by all stakeholders involved. It has been and continues to be a challenge for the Department to complete the audit and meet OMB's reporting deadline given the complexity of our financial operations.

The Department maintains a strong commitment to corporate governance and improving our internal controls. Therefore, we are also pleased that the Independent Auditor did not identify any deficiencies in internal control that they consider to be material weaknesses. The Report on Internal Controls cites six significant deficiencies that align themselves closely with those identified and reported by our Management Control Steering Committee. As reflected in the report, the Department has made progress in strengthening our financial processes and controls, but we also acknowledge that additional work is needed to address the reported significant deficiencies. We are committed to build on the progress made over the last year to further address these issues. We will work collaboratively and constructively with Kearney and your office on the issues identified in the Report to implement improvements and ensure their resolution.

We thank you for the opportunity to comment on the draft report. 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, and the Department remains committed to improving the management of its programs and the quality of its financial reporting.