United States Department of State
and the Broadcasting Board of Governors

Inspector General

DEC 1 2 2008

UNCLASSIFIED

INFORMATION MEMO TO THE SECRETARY

FROM: OIG – Harold W. Geisel, Acting

SUBJECT: Independent Auditor's Report on the U.S. Department of State's 2008 and 2007 Financial Statements (AUD/FM-09-02A)

The Office of Inspector General (OIG) contracted with the independent certified public accounting firm of Leonard G. Birnbaum and Company, LLP (LGB), to audit the financial statements of the Department of State as of September 30, 2008 and 2007, and for the years then ended. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; Office of Management and Budget (OMB) audit guidance; and the *Financial Audit Manual*, issued by the Government Accountability Office and the President's Council on Integrity and Efficiency.

In a report dated November 17, 2008, LGB stated that because the Department was unable to respond to requests for evidential material in a timely manner and LGB was not able to perform other auditing procedures to satisfy itself as to the accuracy of the 2008 financial statements in time to meet the November 17, 2008, deadline imposed by OMB for issuing the report, the scope of its work was not sufficient to enable it to express, and it did not express, an opinion on the financial statements as of, and for the year ended, September 30, 2008.

The Department has since provided LGB with sufficient evidential material to support the amounts reported on the financial statements as of, and for the year ended, September 30, 2008. LGB has satisfied itself that the amounts presented in the Department's 2008 financial statements are presented fairly in all material respects in conformity with accounting principles generally accepted in the United States of America. Accordingly, the present opinion on the Department's 2008 financial statements is different from the disclaimer of opinion identified in the previous report dated November 17, 2008, and that report should not be relied upon.

LGB found the following:

- certain deficiencies in the Department's internal control that LGB considered to be significant deficiencies,

- instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management system, and

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- that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

LGB is responsible for the auditor's report dated December 12, 2008, attached to this memorandum, and the conclusions expressed in the report. 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 complied with FFMIA.

Comments from the Bureau of Resource Management are included in the attached report in Appendix A.

OIG appreciates the cooperation extended to it and LGB by Department managers and staff during the conduct of this audit.

Attachment: As stated.

Independent Auditor's Report

U.S. Department of State's Financial Statements

September 30, 2008 and 2007

AUD/FM-09-02A, December 2008

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INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We have audited the Department of State's (Department) Consolidated Balance Sheets, Consolidated Statements of Net Cost, Consolidated Statements of Changes in Net Position, and Combined Statements of Budgetary Resources (annual financial statements) as of, and for the years ended, September 30, 2008 and 2007. We have considered internal control over financial reporting as of, and during the year ended, September 30, 2008, and we have tested compliance with selected laws and regulations.

In our report dated November 17, 2008, we stated that because the Department was unable to respond to requests for evidential material in a timely manner and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the 2008 financial statements in time to meet the November 17, 2008, deadline imposed by the Office of Management and Budget (OMB) for issuing our report, the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements as of, and for the year ended, September 30, 2008.

On November 14, 2007, we issued our report on the Department's financial statements as of, and for the year ended, September 30, 2007. In that report, we disclaimed an opinion on the Department's 2007 annual financial statements because the Department was unable to respond to requests for evidential material in a timely manner and we were not able to perform auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2007, deadline imposed by OMB for issuing our report.

The Department has since provided us with sufficient evidential material to support the amounts reported on the financial statements as of, and for the year ended, September 30, 2008. We have satisfied ourselves that the amounts presented in the Department's 2008 financial statements are presented fairly in all material respects in conformity with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the Department's 2008 financial statements, as presented herein, is different from the disclaimer of opinion identified in our previous report dated November 17, 2008, and that report should not be relied upon. While the Department provided sufficient evidential material to support the opening balances for its 2008 financial statements, we did not perform additional auditing procedures on

the 2007 financial statements. Therefore, we continue to be unable to express, and do not express, an opinion on the 2007 financial statements.

We found the following:

- certain deficiencies in the Department's internal control that we considered to be significant deficiencies,
- instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management systems, and
- that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

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

ANNUAL FINANCIAL STATEMENTS

In our opinion, the Department's 2008 financial statements, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 2008, and the net cost of operations, the changes in net position, and the use of budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

On November 14, 2007, we issued our report on the Department's financial statements as of, and for the year ended, September 30, 2007. In that report, we disclaimed an opinion on the Department's 2007 annual financial statements because the Department was unable to respond to requests for evidential material in a timely manner and we were not able to perform auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2007, deadline imposed by OMB for issuing our report. While the Department provided sufficient evidential material to support the opening balances for its 2008 financial statements, we did not perform additional auditing procedures on the 2007 financial statements. Therefore, we continue to be unable to express, and do not express, an opinion on the 2007 financial statements.

INTERNAL CONTROL

In planning and performing our audits of the Department's annual financial statements as of, and for the years ended, September 30, 2008 and 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the annual financial statements but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we

do not express an opinion on the effectiveness of the Department's internal control. We limited our consideration of internal control to those controls necessary to achieve the objectives described in OMB Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. We did not consider all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

The purpose of internal control is to provide management with reasonable, but not absolute, assurance that the following objectives are met:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;

- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and

- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that OMB, Department management, or the Office of Inspector General has identified as being significant for which compliance can be objectively measured and evaluated.

Our consideration of the internal control over financial reporting would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A control deficiency 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 misstatements on a timely basis. Under standards issued by the American Institute of Certified Public Accountants, a significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following four deficiencies to be significant deficiencies in internal control:

- The Department's financial and accounting system as of September 30, 2008, was inadequate. There is a risk of materially misstating financial information under the current conditions. This condition is a significant reason that the Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner, which led to our inability to express an opinion on the 2008 financial statements in time to meet the deadline imposed by OMB. The principal areas of inadequacy were the following:

- The Department is unable to produce year-end financial data to be included in its Agency Financial Report in a timely manner.

- The Department has not established or implemented effective information technology application controls for management of grants and other forms of financial assistance.

This deficiency was initially observed in our audit of the Department's 1997 financial statements and cited in subsequent audits.

- The Department's internal control process related to the management of undelivered orders was inadequate. The Department has made improvements in this area over the past several years. The Bureau of Resource Management (RM) has actively worked with other Department bureaus to validate undelivered orders and has successfully cleared up a significant number of obligations that were outstanding from past years. The Department, however, needs to perform additional work to correct this condition. Our tests indicated that excess obligations as of September 30, 2008, were approximately $200 million. Also, we noted that the Department's undelivered orders balance had grown to $15.4 billion as of September 30, 2008. The Budget and Accounting Procedures Act of 1950 requires that the Department's accounting system provide effective control over funds. Failure to deobligate funds in a timely manner may result in the loss of availability of those funds. The deficiencies in this process were cited in our report on the Department's 1997 financial statements and in subsequent reports.

- We have identified deficiencies related to the recording of personal property and related depreciation expense and accumulated depreciation. The Department's control over property acquired by, and in the hands of, contractors, while improved, has not fully matured. Further, weaknesses in the Department's controls over vehicles and other personal property have persisted. Our tests disclosed a continuation of assets acquired in prior years being reported as current year accessions and errors in depreciation resulting from incorrect in-service dates. The Department has begun to implement policies, which, if executed as designed, should effectively address this long-standing weakness. This deficiency was initially observed in our audit of the Department's 2005 financial statements and cited in subsequent reports.

- The Department is unable to determine the extent of its unfunded actuarial liability accruing from defined benefit supplemental pension plans for locally employed staff. This deficiency was initially observed in our report on the Department's 2007 financial statements.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements

will not be prevented or detected by the entity's internal control. We noted no matters that we considered to be material weaknesses as defined herein.

We are required to review the Department's current FMFIA report and disclose differences with the material weaknesses in our report. We did not identify any discrepancies.

We noted certain other internal control issues that we have reported to Department management in a separate letter dated November 17, 2008.

COMPLIANCE WITH LAWS AND REGULATIONS

Department management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the 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 07-04, including the requirements in FFMIA. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. The objective of our audit of the annual financial statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions in statutes and regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or that sensitivity warrants disclosure thereof.

The results of our tests of compliance with the laws and regulations described above, exclusive of FFMIA, disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards,* issued by the Comptroller General of the United States, and OMB Bulletin 07-04.

- 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. However, we found that the Department's financial system (1) does not provide effective control over personal property, (2) does not manage undelivered orders effectively, and (3) is unable to issue year-end financial data in a timely manner.

- Federal Managers' Financial Integrity Act of 1982. This act requires the implementation of internal accounting and administrative controls that provide reasonable assurance that (1) obligations and costs are in compliance with applicable

laws; (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures applicable to Department operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets. However, as discussed above, we found that the Department's financial system does not provide effective control over personal property and does not manage undelivered orders effectively. Hence assets are not adequately protected from waste or loss.

- 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 that is responsive to the financial information needs of agency management; (ii) the development and reporting of cost information; (iii) the integration of accounting and budgeting information; and (iv) the systematic measurement of performance. However, we found that the Department's financial system does not produce year-end financial data in a timely manner.

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

The above areas of noncompliance were cited in our audit of the Department's 1997 financial statements and subsequent audits.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance. Compliance with FFMIA is discussed below.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with federal financial management system requirements, applicable accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on January 4, 2001. OMB implementation guidance states that agencies that can do the following would be substantially compliant with FFMIA:

- prepare financial statements and other required financial and budget reports using information generated by the financial management system(s);

- provide reliable and timely financial information for managing current operations;

- account for their assets reliably so they can be properly protected from loss, misappropriation, or destruction; and

- do all of the above in a way that is consistent with federal accounting standards and the Standard General Ledger.

The results of our tests disclosed instances, described below, where the Department's financial management systems did not, in our view, substantially comply with the requirement to follow the federal financial management system requirements.

- Circular A-127 requires that the Department's systems support management's fiduciary role by providing complete, reliable, consistent, timely, and useful financial management information. Based on the deficiencies related to financial management systems discussed in the report on internal controls and the preceding paragraphs in the report on compliance with laws and regulations, we determined that the Department was not substantially in compliance with this standard.

In addition, we were initially unable to express an opinion on the annual financial statements as of, and for the year ended, September 30, 2008, because of limitations on the scope of our work. The Department was unable to respond to requests for evidential material in a timely manner, and we were not able to satisfy ourselves as to the accuracy of the financial statements in time to meet the deadline imposed by OMB.

RM has overall responsibility for the Department's financial management systems. The foregoing noncompliance has its roots in the lack of organization and integration of the Department's financial management systems. In our audits of the Department's financial statements since 1997, we observed that the Department's financial management systems were not in compliance with FFMIA and recommended, in connection with our audits of the Department's 1997 and 1998 Principal Financial Statements, that a remediation plan be prepared. RM submitted its plan to remediate noncompliance with FFMIA to OMB on March 16, 2000.

We noted certain other instances of noncompliance that we reported to the Department's management in a separate letter dated November 17, 2008.

RESPONSIBILITIES AND METHODOLOGY

Department management has responsibility for the following:

- preparing the annual financial statements, required supplementary information, and other accompanying information in conformity with accounting principles generally accepted in the United States of America;

- establishing and maintaining effective internal control; and

- complying with applicable laws and regulations.

Our responsibility is to express an opinion on the financial statements based on our audit. Auditing standards generally accepted in the United States of America require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and presented fairly in accordance with accounting principles generally accepted in the United States of America. We considered the Department's internal control for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the financial statements.

In order to fulfill these responsibilities, we took the following actions:

- We examined, on a test basis, evidence supporting the amounts on the annual financial statements and related disclosures.

- We assessed the accounting principles used and significant estimates made by management.

- We evaluated the overall presentation of the annual financial statements.

- With respect to the Department's internal control over financial reporting, we obtained an understanding of the design effectiveness of internal controls, determined whether they had been placed in operation, assessed control risk, and performed tests of controls.

- We obtained an understanding of the process by which the Department identifies and evaluates weaknesses required to be reported under FMFIA and related Department implementing procedures.

- We tested compliance with selected provisions of laws and regulations that may have a direct and material effect on the financial statements.

- We obtained written representations from management.

- We performed other procedures as we considered appropriate under the circumstances.

Our audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in the *Government Auditing Standards,* and the provisions of OMB Bulletin 07-04. We considered the limitations on the scope of our work in forming our conclusions.

The Management's Discussion and Analysis and Required Supplementary Information are supplementary information required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

This report is intended solely for the information and use of Department management, the Inspector General of the U.S. Department of State and Broadcasting Board of Governors, OMB, the Government Accountability Office, the Department of the Treasury, and the Congress and is not intended to be and should not be used by anyone other than those specified parties. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by Department management on this report are included in Appendix A to this report. The written response by Department management to the significant deficiencies identified in our report has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion on these comments.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
December 12, 2008

UNCLASSIFIED

MEMORANDUM

TO: OIG/AUD – Mr. Mark Duda

FROM: RM – Bradford R. Higgins

SUBJECT: Draft Audit Report on the Department of State's 2008 and 2007 Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the U.S. Department of State's 2008 and 2007 Financial Statements" (Report).

The Department of State (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 face daily. Despite these complexities, the Department pursues a commitment to financial integrity, transparency, and accountability that is the equal of any multi-national corporation.

It will always be a challenge for the Department to complete the audit and meet OMB's 45-day deadline given the complexity of our financial operations. With the tight timeframe for submitting audited statements (45 days versus 60 days in the corporate world), any major program change jeopardizes the ability to complete the audit on-time, and each year will bring challenges such as accounting for contractor held property in Iraq and Afghanistan and increased spending through allocations to other agencies for programs such as HIV/AIDS. As a direct result of these time constraints, we were disappointed that while the Department submitted its FY 2008 financial report to OMB on time, we received a disclaimer of opinion from the Independent Auditor because of a delay in providing certain evidential matter in a timely manner. Since that submission and disclaimer on November 17, with the cooperation of the Independent Auditor and the OIG, our efforts continued, and we were able to satisfy the Independent Auditor about the amounts presented in the FY 2008 financial statements and footnotes. Therefore, on December 12, 2008, we have now received an unqualified ("clean") opinion on the financial statements as, and for the year ended September 30, 2008.

Additionally, we are pleased about the progress we made in FY 2008 to improve our internal controls. The Department is committed to effective internal controls and throughout 2008 we worked closely with the Independent Auditor to address the material weaknesses in accounting for personal property and the management of undelivered orders reported in their FY 2007 *Independent Auditor's Report*. As a result, and as reflected in the Report, the Independent

Auditor downgraded these items to significant deficiencies, and reports no material weaknesses in internal controls. Accordingly, for FY 2008, the Secretary was able to provide an overall unqualified statement of assurance to the FMFIA, and an unqualified statement of assurance for internal controls over financial reporting.

With respect to the significant deficiency for accounting for personal property, we will continue our efforts in FY 2009 to address the many causes of this deficiency for our multitude of global assets (aircraft, vehicles, security equipment). Our actions have improved our controls from a year ago, but more work remains and further corrective actions are planned for FY 2009. In FY 2009, the Senior Assessment Team (SAT) and Management Control Steering Committee (MCSC) will ensure that efforts to address weaknesses in this area continue.

The Report cites a significant deficiency for the management of undelivered orders, and notes that there have been improvements in this area as evidenced by the downgrading of this previously reported material weakness. Improvements in the management of undelivered orders will continue to be a priority for the Department in FY 2009. Further corrective actions are already underway including the distribution of aging reports, and using recently developed enhancements to our Global Financial Management System (GFMS) capabilities to automate deobligations. In addition, actions to improve contract and grant closeout procedures relative to undelivered orders are being enhanced, and the SAT will be actively engaged with the implementation and oversight of these corrective actions.

Significant improvements in the Department's management of Federal financial assistance were made in FY 2008, and the MCSC (with the OIG's concurrence) voted to downgrade and consider resolved a number of areas (e.g., lack of adequate policies and training) that had contributed to this significant deficiency. In regards to the lack of effective information technology application controls for the management of grants, in FY 2008 the Department selected the GrantsSolutions.gov system, operated by the Department of Health and Human Services, as its grants management system service provider under OMB's Grants Management Line of Business initiative. GrantsSolutions.gov will automate the full range of assistance management activities, from solicitation through award, post-award monitoring, and closeout and will also interface with the GFMS.

In FY 2007, the Department implemented the GFMS as the next step in our multiyear effort to establish a single global financial system. GFMS replaced the Department's 20 year old Central Financial Management System (our core accounting system) that centrally accounts for the Department's billions of dollars of finances through over 5 million annual transactions by 1,000+ users and over 25 "handshakes" with other internal and external systems. As part of the implementation of GFMS, a data warehouse, fixed asset module and a cost allocation module

(for managerial cost accounting) were installed. In addition, we brought on a new customer, the International Boundary and Water Commission, providing a full range of financial management services. And, for the first time, the Department's acquisition and fixed asset systems have been integrated into a single software application. GFMS is already paying for itself with the recovery of millions of dollars from over-billings, while also providing the data platform that will enable RM to provide more timely financial information and prepare in-depth decision support data for senior management. During FY 2008, we have stabilized GFMS and are moving forward with plans to establish a virtual, single global financial management system.

With respect to the significant deficiency for defined benefit supplemental pension plans for locally employed staff, the Department will continue our efforts in FY 2009 to establish an accurate inventory of these plans. This will serve as a basis to work and establish an appropriate approach to determining any unfunded actuarial amounts.

The Department continues to make progress in implementing Managerial Cost Accounting Standards, and we are pleased that based on our efforts the Independent Auditor no longer considers this a significant deficiency.

We thank you for the opportunity to comment on the draft report. Our work with the Independent Auditor and your office over the past 10 years has been collaborative, productive, and a catalyst for positive change. We would like to extend our appreciation to Leonard G. Birmbaum and Company, LLP, for their dedicated efforts on this year's audit. We believe, as detailed above, that considerable progress on a number of matters has been made this year, and the Department remains committed to improving the management of its programs and the quality of its financial reporting.