United States Department of State
and the Broadcasting Board of Governors

*Office of Inspector General*

November 15, 2011

**INFORMATION MEMO FOR THE SECRETARY**

FROM: OIG – Harold W. Geisel

SUBJECT: Independent Auditor's Report on the U.S. Department of State 2011 and 2010 Financial Statements (AUD/FM-12-05)

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, 2011 and 2010, 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 identified potentially material amounts relating to after-employment benefits provided to locally employed overseas staff that had not been previously reported in the Department's financial statements. The Department was unable to provide timely and complete evidential matter to enable Kearney & Company to perform audit procedures to satisfy itself that actuarial liabilities and benefit plan assets relating to after-employment benefit programs, and their related effect on net position, were free of material misstatements. As a result of these limitations, Kearney & Company's present opinion on the Department's FY 2010 consolidated balance sheet and related statement of changes in net position is different from that expressed in its previous report, and the previous opinion should not be relied upon.

Except for the effects of such adjustments, if any, as might have been determined to be necessary had Kearney & Company been able to examine evidence related to after-employment benefits provided to locally employed overseas staff, Kearney & Company found

- the consolidated balance sheets as of September 30, 2011 and 2010, and the related consolidated statements of net cost and changes in net position and combined statements of budgetary resources for the years then ended, including the accompanying notes, present fairly, in all material respects, the financial position of the Department as of September 30, 2011 and 2010, and its net cost of operations, changes in net position, and changes in budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America;

- 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 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, dated November 14, 2011, 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 by Department managers and staff during the conduct of this audit.

Attachments: As stated.

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[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**
AUD/FM-12-05

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, 2011 and 2010, 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.

In our report dated November 14, 2010, we expressed an opinion that the consolidated balance sheet, and the related consolidated statements of net cost and changes in net position, and the combined statement of budgetary resources, including the accompanying notes, present fairly, in all material respects, the financial position of the Department as of September 30, 2010, and its net cost of operations, changes in net position, and changes in budgetary resources for the year then ended in conformity with accounting principles generally accepted in the United States of America.

During FY 2011, our audit procedures identified potentially material amounts relating to after-employment benefits provided to locally employed overseas staff that had not been previously reported in the Department's financial statements. These issues affect FY 2011 and FY 2010 balances and activity. The Department was unable to provide timely and complete evidential matter to enable us to perform audit procedures to satisfy ourselves that actuarial liabilities and benefit plan assets relating to after-employment benefit programs, and their related effect on net position, were free of material misstatements. As a result of these limitations, our present opinion on the Department's FY 2010 consolidated balance sheet and related statement of changes in net position, as presented herein, is different from that expressed in our previous report. Our previous opinion should not be relied upon.

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As discussed in Note 20 to the FY 2011 financial statements, the Department restated its FY 2010 financial statements to correct errors identified during the FY 2011 financial statement audit related to amounts reported as after-employment actuarial liabilities, benefit plan assets, and net position.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to after-employment benefits provided to locally employed overseas staff, the financial statements referred to above, including the accompanying notes, present fairly, in all material respects, the financial position of the Department as of September 30, 2011 and 2010, and its net cost of operations, changes in net position, and changes in budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Department's Management's Discussion and Analysis and other Required Supplementary 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, 2011, 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, 2011. Our report on internal control includes a discussion of significant internal control deficiencies related to after-employment benefits for locally employed overseas staff that led to the restatement of the FY 2010 financial statements. 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 with laws and regulations. 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, 2011

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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, 2011, and have issued our report dated November 14, 2011. 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. 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 but not to provide an opinion on internal control. 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 the Management's Discussion and Analysis section.

We limited our internal control testing to those controls necessary to achieve OMB Bulletin No. 07-04, as amended, 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 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 and compliance 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. Therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies. We consider the following deficiencies in the Department's internal control to be material weaknesses.

## Material Weaknesses

### I. Financial Reporting

The Department compiles its financial statements through a multistep process using a combination of manual and automated procedures. Neither the Department's Global Financial Management System (GFMS) nor Hyperion, which is the system used to produce the proprietary trial balance, is 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 (SNC), 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 (SBR). 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 FY 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 to reduce the material weakness; however, during FY 2011, the audit process identified the additional control deficiencies noted, which, when combined, result in a material weakness.

- Preparation of the SBR – The SBR is predominantly derived from an entity's budgetary general ledger in accordance with budgetary accounting rules. Information on the SBR should reconcile to budget execution information reported to the Department of the Treasury (Treasury) on Standard Forms (SF) 133, Report on Budget Execution and Budgetary Resources, and with information reported in the Budget of the United States Government to ensure the integrity of the numbers presented. We noted that the Department does not perform effective fund reconciliation procedures for budgetary resources at the transaction level in a timely manner. We found that the Department makes numerous adjustments related to budgetary resources outside the financial system,

most of which originate from automated calculations as well as manual journal entries. The audit process identified a number of significant errors in the manual preparation of the Department's SF 133 workbooks.

The Department does not use the full functionality of its financial systems to capture and control all accounting events (including budgetary transactions) and to automate SBR reporting procedures. The manual nature of the current process the Department uses to compile its SBR is high risk and resource intensive. The process requires significant intervention on the part of management, and it increases the risk of error and the risk that an auditable SBR will not be prepared timely to meet OMB financial reporting deadlines. In addition, the lack of a fully integrated budgetary accounting system jeopardizes compliance with the Federal Financial Management Improvement Act (FFMIA). Significant audit adjustments are required as a result of errors found.

- Abnormal Balances – The U.S. Standard General Ledger (USSGL) is a series of account numbers that Federal agencies use to maintain their transaction-level accounting information. Each general ledger account normally has a debit balance or a credit balance. The Department enters accounting information into GFMS at the transaction level. To report consolidated information in its annual financial statements, the Department combines and reports transaction-level information at the fund (appropriation) and Department level. We identified more than 300 general ledger accounts and sub-accounts that had abnormal balances as described in Treasury guidance. The Department does not have a process in place to prevent, detect, and remediate abnormal general ledger balances in a timely manner. The presence of abnormal balances compromises the integrity of financial data and increases the risk of errors on the financial statements.

- Budgetary to Proprietary Accounts Reconciliation – Federal financial accounting standards require an entity to be able to reconcile its proprietary information to budgetary information. The Department does not routinely complete a timely and comprehensive reconciliation of budgetary and proprietary account relationships as part of the financial reporting process. The lack of a fully integrated accounting system that simultaneously records both the proprietary and budgetary impact of an accounting event contributes to the Department's inability to timely perform a complete reconciliation. Completing a budgetary to proprietary account reconciliation is not part of the Department's financial reporting control structure, and the absence of this reconciliation increases the risk that material errors may go undetected and uncorrected.

- Periodic Analysis of Financial Data – Periodic reviews and comparative analyses of financial data are effective tools used by many organizations to identify abnormalities and potential misstatements in accounting records. Properly designed and executed analytical comparisons help management identify significant variances in account balances. The Department did not perform standardized, comparative analyses over accounts included in the SNC and the SBR. While some analyses were performed on balance sheet accounts, these analyses were insufficient to meet financial reporting

control objectives. The Department did not have a standardized process for periodic comparative reviews of financial data, including standard thresholds to trigger investigations of variances and requirements for supporting documentation. Without effective routine financial reviews, material errors and anomalies in the financial statements may not be identified and corrected.

- Allocation Methodology for the SNC – An agency's SNC should present the net cost of operations for an agency by major program. The major programs should relate to the major goals and outputs described in the entity's strategic and performance plans, as required by Federal standards. The Department uses a methodology to allocate costs across strategic goals that was developed in FY 2004 and subsequently updated to reflect changing conditions or introductions of new programs. The Department was unable to provide adequate documentation to support the allocation methodology, including underlying assumptions. The Department does not have a process to periodically review and validate its cost allocation methodology in light of changing conditions and strategic goal adjustments. Documentation was not sufficiently maintained to support historical validation efforts. Without a valid cost allocation methodology, the SNC may not represent actual cost data for management comparisons. Further, the inability of an agency to produce managerial cost information consistent with Federal accounting standards is an indicator of noncompliance with the FFMIA.

## II. Foreign Service National After-Employment Benefits

The Department provides some Foreign Service National (FSN) employees with after-employment benefits through a variety of arrangements, including defined benefit retirement plans, defined contribution retirement plans, lump-sum retirement payments, and separation benefits to FSNs who voluntarily resign or otherwise leave the workplace. The Department does not maintain a comprehensive list of FSN after-employment benefit plans by post. In addition, the Department lacks sufficient policies and procedures to effectively manage and account for these benefits. Based on the material misstatements identified during the audit, the Department restated its FY 2010 financial statements and made adjustments to benefit plan assets, actuarial liabilities, and net position during FY 2011. The individual deficiencies we identified are summarized as follows:

- FSN Defined Benefit Plans – In prior years, the Department performed analyses to identify posts offering defined benefit plans to FSN employees and to estimate unfunded defined benefit liabilities for countries identified during its analyses. During FY 2011 audit site visits, we reviewed the details of benefit arrangements for a sample of posts known to offer defined benefit plans to FSN employees. We found that the liability estimate that the Department had recorded in prior years was not supported by information from local actuaries, and in some cases, the actuarial reviews were not performed using consistent estimation techniques and assumptions. We also noted that the Department had recorded a net liability for the defined benefit plans rather than recording assets and liabilities separately, as is required by Federal accounting standards. In addition, we identified posts that had defined benefit plans that were not included in the Department's

estimated liability. Certain data elements necessary to report FSN defined benefit plans in accordance with applicable accounting standards were not readily available for all plans. In addition, posts with defined benefit plans inconsistently managed key processes, such as periodic actuarial valuations, experience studies, and plan investments. Expanded oversight is needed, as the solvency of defined benefit plans can be sensitive to management decisions such as the establishment of contribution rates and investment strategies.

- FSN Lump Sum Retirement and Voluntary Separation Benefits – We identified numerous posts providing FSNs either lump sum retirement or voluntary separation benefits. The Department had not recorded an estimated liability for these benefits, in accordance with relevant accounting standards. A relevant and repeatable process is necessary to reasonably estimate liabilities for these benefits. The lack of oversight related to FSN after-employment benefits may result in funding shortfalls, noncompliance with local employment regulations, or the disbursement of improper benefit payments.

- FSN Defined Contribution Plans – The Department has established the FSN Defined Contributions Retirement Plan Fund (DCF) as a centralized retirement savings program that posts can participate in to provide benefits upon separation to locally employed FSNs. The Department reports the assets for the FSN DCF as Cash and Other Monetary Assets on its balance sheet and also in the footnotes to the financial statements as an Earmarked Fund. Since the Department has chosen to record this fund as an asset, it also needed to record a corresponding liability, which it had not done in prior years. In addition, we noted that the Department did not report information in its financial statements on defined contribution retirement plans offered at individual posts that are separate from the FSN DCF.

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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

### III. Property and Equipment

The Department reported over $13 billion in net property and equipment (P&E) on its FY 2011 balance sheet. Real and leased property assets consist primarily of facilities used for U.S. diplomatic missions abroad and capital improvements to these facilities. Personal property consists of several asset categories, including aircraft, vehicles, security equipment, communication equipment, and software. Weaknesses in property were initially reported in the audit of the Department's FY 2005 financial statements and subsequent audits. In FY 2011, the Department's internal control structure continued to exhibit several deficiencies that negatively

affect the Department's ability to account for real and personal property in a complete, accurate, and timely manner. We concluded that the combination of property-related control deficiencies was a significant deficiency. The individual deficiencies we identified are summarized as follows:

- International Boundary and Water Commission (IBWC) Real Property – IBWC is a Federal commission that has responsibility for applying the boundary and water treaties between the United States and Mexico and settling differences that may arise in their application – a mission that involves a significant amount of real property. For consolidated financial reporting purposes, IBWC financial information is included in the Department's financial statements. During our audit, we found that IBWC had not recognized and reported a significant, multiyear improvement project constructed by another entity on behalf of IBWC. As a result of the omission of certain improvements, the IBWC real property information provided to the Department for financial reporting purposes was understated. The Department did not have an effective, routine process in place to ensure that property information provided by IBWC was complete and accurate.

- Personal Property – The Department reported over $1 billion in net personal property as of September 30, 2011. 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.

- Internal Use Software and Software-in-Development – 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 all relevant projects were being capitalized, 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. In addition, we also noted errors in manual cost tracking schedules and depreciation calculations.

- Capital Leases – The Department manages approximately 8,900 real property leases throughout the world. Capital leases are leases that transfer substantially all the benefits and risks of ownership to the lessee; therefore, the asset must be capitalized and shown in the lessee's balance sheet. The Department's internal control structure did not ensure the accuracy of capitalized amounts or ensure that all leases recorded as being capital fully met the capitalization criteria. In addition, amortization schedules and net present value calculations were manually created and were therefore susceptible to error.

- Heritage Assets – 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 in the notes to the financial statements. Our audit procedures identified significant collections of heritage assets that had not been included in the Department's note disclosure. In addition, we noted incomplete reviews and reconciliations of heritage item counts and inaccurate reporting of condition assessments. We also noted inconsistent treatment of grouped heritage assets, such as a set of fine cutlery or a furniture collection. 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 show that it is sufficiently responsible and accountable for these assets.

## 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. In our report on the Department's FY 2010 financial statements, we identified budgetary accounting as a significant deficiency. During FY 2011, the Department did not implement sufficient corrective actions to remediate existing deficiencies, and we concluded that the combination of control deficiencies was a significant deficiency. The individual deficiencies we identified are summarized as follows:

- Effectiveness of Allotment Controls – Federal agencies use allotments to allocate funds in accordance with OMB apportionments or other statutory authority. Allotments provide authority to incur obligations to agency officials as long as those obligations are within the scope and terms of the allotment authority. The Department's accounting systems have automated controls to prevent the posting of obligations that exceed available allotment funding authority; however, these controls were overridden by Department personnel. The audit process identified 391 instances in which the allotment funds control was overridden in a 3-month period. Since the Department does not have an integrated budgetary financial reporting system, breakdowns in allotment funds control further strain the manual, labor-intensive process to develop the SBR. Overriding the allotment funds control could lead to a violation of the Antideficiency Act, and it increases the risk of fraud, misuse, and waste.

- Unsupported Obligations – Obligations are definite commitments that create a legal liability of the Government for payment. The Department should record obligations based upon a reasonable estimate of the Department's potential liability. The audit process identified 4,691 low-value obligations for which the Department could not provide evidence of a binding agreement to support these 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 or services, the Department establishes low-value obligations, allowing invoices to be paid in compliance with the Prompt Payment Act but effectively bypassing system internal controls. The continued use of this practice could lead to a violation of the Antideficiency Act, and it increases the risk of fraud, misuse, and waste.

- Timeliness of Obligations – The Department should record an obligation in its financial management system when it enters into an agreement, such as a contract or a purchase order, to purchase goods and services. During our testing, we noted 46 obligations that were not recorded within 15 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. The Department did not have adequate procedures and controls to ensure the accurate and timely creation, approval, and recording of obligations. Without an effective process to create obligations timely, controls to monitor funds and make timely payments may be comprised, which may lead to violations of the Antideficiency Act and the Prompt Payment Act.

- Incomplete Budgetary Authority – The Department records budgetary authority, including congressionally appropriated funding, rescissions, and intra-governmental transfers, in its budgetary and financial management systems. The Department reconciles budgetary information in its systems to the Treasury Governmentwide Accounting and Reporting Program – a real-time budgetary information system. During our testing, we found that the Department's financial system did not accurately or completely reflect budgetary authority. The Department does not always record budgetary authority in a timely manner, and it relies on manual processes to prepare its budgetary financial reports. Many adjustments are made outside of the budgetary and financial systems for financial reporting purposes, which increases the risk of error.

- Capital Lease Obligations – The Department is required to obligate funds to cover the net present value of the Government's total estimated legal obligation over the life of a capital lease contract. The Department annually obligates funds equal to one year of the capital lease cost rather than the entire amount of the lease agreement, as required. The Department obligates leases on an annual basis rather than the entire lease agreement period because that is the manner in which funds are budgeted and appropriated by Congress.

## V. Validity and Accuracy of Unliquidated Obligations

Unliquidated obligations (ULO) 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 audit process identified approximately $214.5 million related to invalid ULOs that had not been identified by the Department's review process. The current internal control structure is not operating effectively to comply with existing policy or facilitate the accurate reporting of ULO balances in the financial statements. The Department's internal controls are not sufficient to ensure that ULOs are consistently and systematically evaluated for validity and deobligation. Weaknesses in controls over ULOs were initially reported in the audit of the Department's FY 1997 financial statements and subsequent audits.

## VI. Accrual Process

The Department provides discretionary financial assistance to foreign countries, international organizations, international societies, commissions, individuals, and not-for-profit organizations through grants and voluntary contributions. Federal agencies should record a liability for all amounts owed as of the financial statement date, including for grants and voluntary contributions. Agencies may need to estimate the liability amount for certain items using an accrual methodology when supporting documentation has not been received from the vendor. Agencies must accumulate sufficient, relevant, and reliable data on which to base accrual estimates, and management should ensure that adequate documentation is available to support the estimates.

- Grants Accrual – The Department was unable to provide adequate documentation to support the data and assumptions that it used to develop and record the domestic grants accrual in a timely manner. Results of the Department's domestic grants accrual validation process indicated weaknesses in the estimation process and data sources used to calculate the liability, which increases the risk of erroneous financial statements. Validation results were received near the end of audit fieldwork and could not be fully substantiated.

- Voluntary Contributions Accrual – The Bureaus of International Organization Affairs (IO) and Population, Refugees and Migration (PRM) are responsible for the majority of voluntary contributions within the Department. Although the Department accrued a liability for IO voluntary contributions, it did not accrue a liability for PRM voluntary contributions as part of its overall accrual process.

## VII. 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 logical access, and an ability to identify and respond to changing risk profiles. The National Institute of Standards and Technology and the Government Accountability Office's (GAO) Federal Information System Controls Audit Manual (FISCAM) provide control objectives and evaluation techniques used during the course of our audit. Weaknesses in IT controls have been reported as a significant deficiency since FY 2009.

In accordance with the Federal Information Security Management Act of 2002 (FISMA), the Office of Inspector General (OIG) performed a review of the Department's information security program for FY 2011. Overall, OIG found that the Department had implemented an information security program, but it identified weaknesses in the areas of risk management strategy, security configuration management, plans of action and milestones, and the continuous monitoring program, which were collectively reported as a FISMA significant deficiency. A significant deficiency is the highest level of severity under FISMA.

While our audit noted similar deficiencies with general support systems as were reported by OIG, our scope was focused primarily on deficiencies that could lead to significant misstatements of the Department's financial statements. Based on IT deficiencies noted with the general support systems, we developed additional audit procedures to substantively test financial management system inputs and outputs that we believe would reasonably ensure that no material misstatements occurred because of general support system deficiencies that we would not have identified during audit testing. Our procedures did not identify any material misstatements that we believe were caused by general support system deficiencies. In addition, the Department reported that it had certain compensating controls that would mitigate some of the risks that were attributable to the general support system weaknesses. Also, in FY 2011, the Department remediated certain financial reporting application deficiencies that we had identified in FY 2010, including documenting controls in some financial applications, improving definitions of user roles and responsibilities, and performing periodic user access reviews. Although the Department had addressed certain deficiencies in financial reporting applications, we noted other deficiencies reported in prior years that had not been addressed and identified some additional deficiencies. Collectively, the deficiencies noted by OIG during the FISMA evaluation and by us during the financial statement audit are considered to be a significant deficiency within the scope of our financial statement audit and are summarized as follows:

- Security Management and Assurance of Systems and Applications – Organizations conduct system certification and accreditation activities to support decisions and conclusions made by the Authorizing Officer to issue an Authorization to Operate for the system. The Department has not performed a current security risk assessment in support of the tri-annual certification and accreditation required activities for OpenNet, the Department's Sensitive but Unclassified network used for financial systems access and interconnectivity. The Department adopted a "pilot" continuous monitoring program in lieu of previous certification and accreditation activities. This change was not effectively communicated to stakeholders and interconnected systems in the System Security Plan. The adopted continuous monitoring program is based on a monitoring tool (iPost) that does not monitor all devices, controls, data, and metrics required and assured under the previous accreditation methodology. A further financial application, the Integrated Logistics Management System, asserted ongoing certification compliance based on the iPost tool monitoring results, which we determined were not reliable in our assessment.

- Segregation of Duties and Review of User Accounts – The Department has not completed a segregation of duties analysis of user rights and authorizations or appropriately assigned rights in GFMS and the Regional Financial Management System (RFMS). Documented procedures for annual account reviews were not maintained for the Consolidated American Payroll Processing System (CAPPS) and the Global Employment Management System (GEMS)/Employee Benefits Information System. In addition, the Department could not demonstrate that system owners annually validated user privileges in GFMS and the Foreign Affairs Retirement and Disability System. Several instances of segregation of duties violations associated with the assignment of user roles were noted in RFMS. 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.

- Untimely Removal of Inactive or Separated Employees' User Accounts – Only current active employees should have access to systems and applications. Entities should monitor and terminate accounts that have been inactive for extended periods. The Department does not cancel system access for separated or inactive users timely. We identified 29 separated employees who had active accounts in two critical applications, including 29 in GEMS and two in the Central Resource Management System. Two user accounts in CAPPS were inactive for over 60 days. Inactive or terminated user accounts may facilitate circumvention of internal controls, which could potentially result in erroneous and improper transactions, embezzlement, unauthorized use, and a weakening of the internal control structure.

- Multiple or Generic Application User Accounts – Users provided with default or generic accounts can access or alter data within systems without being personally identified. Users should be provided one single access account to a system, which clearly identifies who they are and the privileges they are provisioned to perform on the system. The Department has not prevented or detected the assignment of multiple or generic user accounts to system users. We identified seven users with multiple access credentials to gain access to systems: six users in GFMS and one user in the Global Foreign Affairs Compensation System (GFACS). An additional user account in RFMS had conflicting rights as both a system administrator and voucher processor.

- Foreign Service National Pay (FSNPay) Controls – FSNPay is an application used by the Department to process payroll for FSNs. The processing and handling of payroll data should be secured from viewing or tampering with the contents by external or internal sources. The Department's FSNPay application has weaknesses in the security of transmitted payroll files and in the segregation of duties controls. These weaknesses are attributable to the age of the system and the inability to leverage current technologies to meet required security control objectives. These weaknesses increase the risk of fraud, unauthorized transactions, or improper access to sensitive information. FSNPay is currently planned to be retired and to be fully replaced by GFACS.

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We identified two material weaknesses, Financial Reporting and FSN After-Employment Benefits, during our audit. The Department reported FSN After-Employment Benefits as a material weakness in its FY 2011 Federal Managers' Financial Integrity Act assurance statement. However, the Department did not identify Financial Reporting as a material weakness. We did not audit the Department's assurance statement, and accordingly, we express no opinion on it.

During the audit, we noted certain other matters that we will report to Department management in a separate letter.

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## STATUS OF PRIOR YEAR FINDINGS

In the Report on Internal Control included in the audit report on the Department's FY 2010 financial statements,[1] we noted several issues that were related to internal control over financial reporting. Our internal control findings are summarized in Table 1.

**Table 1. Prior Year Significant Internal Control Deficiencies**

| Control Deficiency | FY 2010 Status | FY 2011 Status |
|---|---|---|
| **Financial Reporting** | Significant Deficiency | Material Weakness |
| **Property and Equipment** | Significant Deficiency | Significant Deficiency |
| **Accounts Payable Accrual** | Significant Deficiency | Management Letter |
| **Budgetary Accounting** | Significant Deficiency | Significant Deficiency |
| **Liability to International Organizations** | Significant Deficiency | Closed |
| **Information Technology** | Significant Deficiency | Significant Deficiency |

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Department management has provided its response to our findings in a separate memorandum attached to this report. We did not audit management's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of Department management; those charged with governance; and others within the Department and OIG, OMB, GAO, the Treasury, and Congress. It is not intended to be and should not be used by anyone other than these specified parties.

Kearney & Company

November 14, 2011

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

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# REPORT ON COMPLIANCE

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, 2011, and have issued our report dated November 14, 2011. 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. 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, that we determined were applicable. As part of our audit, we also performed tests of compliance with 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 of laws and regulations 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 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 as follows:

- *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 that were potentially in violation of the Antideficiency Act.

- *Prompt Payment Act.* 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. The Department did not always make

payments within 30 days, as is required. 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 and that payments to international organizations were not paid in accordance with the Prompt Payment Act.

- *Federal Acquisition Regulation.* Federal procurement regulations require that signatories to agreements that legally bind the Federal Government act within their delegated contracting authority. Failure to follow these regulations is a violation that creates an unauthorized commitment. Resolution of unauthorized commitments requires ratification of a contract in accordance with Federal regulations. When testing obligations, we noted instances of contracting officers exceeding their delegated authority. Additionally, we noted that these contracts had not been properly ratified in accordance with the Federal Acquisition Regulation.

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, as described, in which the Department's financial management systems and related controls did not substantially comply with certain Federal system requirements, Federal accounting standards, and the USSGL at the transaction level.

Federal Financial Management Systems Requirements

- The Department did not have a routine process to reconcile budgetary and proprietary accounts, and the Department could not provide a reconciliation 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 fully maintained in certain financial systems.
- Automated controls to prevent postings of obligations that exceeded available allotment funding authorities were overridden. In addition, transactions could be posted to invalid allotment codes.
- Interest on overdue payments was not always calculated correctly on domestic payments and was not always paid on overdue overseas payments.
- During its annual evaluation of the Department's information security program, as required by the Federal Information Security Management Act, the Department's Office of Inspector General (OIG) identified weaknesses with computer security that it reported collectively as representing a significant deficiency.

Applicable Federal Accounting Standards

- The Department was unable to obtain an unqualified opinion on its FY 2011 financial statements.
- The Department's core accounting system did not produce complete, auditable financial statements without significant manual adjustments. This resulted in a material weakness on financial reporting in our Report on Internal Control.
- The Department did not previously report Foreign Service National after-employment benefits in accordance with Federal accounting standards, which was reported as a material weakness during the Department's OMB Circular A-123 review, as well as in our Report on Internal Control.

Standard General Ledger at the Transaction Level

- The Department's statement of budgetary resources was subject to numerous adjustments that were made outside 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.
- The Department did not have a process to periodically review and validate its cost allocation methodology in light of changing conditions and strategic goal adjustments.
- The Department did not have a process to review and validate abnormal balances in its accounting system.

The Department has not implemented and enforced systematic financial management controls to ensure substantial compliance with FFMIA. The Department has not developed and executed remediation plans to address instances of noncompliance. The Department's ability to meet Federal financial management system requirements and fully process transaction-level data in accordance with the USSGL is hindered by systemic limitations in systems and processes.

Except as noted above, our tests of 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.

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Department management has provided its response to our findings in a separate memorandum attached to this report. We did not audit management's response and, accordingly, we express no opinion on it.

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 OIG, OMB, the Government Accountability Office, the Treasury, and Congress, and it is not intended to be and should not be used by anyone other than these specified parties.

November 14, 2011

United States Department of State

*Chief Financial Officer*

*Washington, D.C. 20520*

UNCLASIFIED

November 15, 2011

MEMORANDUM

TO: OIG – Harry W. Geisel

FROM: RM – James L. Millette

SUBJECT: Draft Audit Report on the Department of State's Fiscal Year 2011 and 2010 Financial Statements

This memo is in response to your request for comments on the Draft Report of the Independent Auditor, Report on Internal Control, and Report on Compliance and Other Matters (Report) of the U.S. Department of State's Fiscal Year 2011 and 2010 Financial Statements.

The Department operates in over 270 locations and 180 countries, conducting its business in more than 135 currencies and in foreign languages, in often the most challenging of environments. It is an immense operational endeavor, impacted on a daily basis by the ever changing nature of international affairs issues and the steady resolve of our foreign policy and leadership in the world. Few agencies or global corporations face these challenges in supporting their operations. We fully understand this and embrace our financial responsibilities to the Department and the American people as we pursue an efficient, accountable, and transparent financial management platform that enhances the Department's foreign affairs mission.

The external audit has become a year-around process and focus for the Department as we strive to deliver meaningful financial statements by November 15 and demonstrate the Department's strong financial management practices. We also do our utmost to meet the challenges of addressing growing audit and compliance requirements, managing and prioritizing improvements in our financial processes and systems, supporting the President's Accountable Governance Initiative, and meeting our day-to-day financial management support obligations. In today's

fiscal climate, how we manage this balance and blend our efforts as financial managers will have added significance as we work to squeeze the most value from our limited resources and execute investment decisions that support our most critical needs. This will be an ongoing challenge for all of us.

The year's audit process has been a concerted and dedicated effort by all stakeholders involved. While we may not agree on every aspect of the process and final outcome of the report, we certainly appreciate the commitment by all parties to work together throughout the audit process to produce our annual financial statements. This year, we received an unqualified opinion for the Statement of Budgetary Resources and the Consolidated Statement of Net Cost. During the year, several issues were identified relating to the financial reporting of after-employment benefits for Foreign Service Nationals (FSN) we employ for all agencies at U.S. diplomatic missions around the world. Accounting for the financial aspects of these complex compensation plans throughout the world presents unique challenges, especially in regards to reporting the future liability for defined benefit, lump-sum retirement, and severance benefits. While we took a number of actions to moderate the most serious aspects of the financial reporting issues, and estimated and recorded amounts in the financial statements, there was insufficient time for the Independent Auditor to perform auditing procedures and satisfy themselves as to the accuracy of these amounts in time to meet the November 15, 2011 deadline. Consequently, as noted in the Draft Report, the Independent Auditor issued a qualified opinion for the Consolidated Balance Sheet and Statement of Changes in Net Position.

As a Department, we remain committed to strong corporate governance and internal controls. We maintain a robust system of internal controls overseen by our Management Control Steering Committee and validated by the senior leadership. For FY 2011, a material weakness was identified by the Department regarding the effective oversight of the Summer Work Program for students traveling to the United States for temporary and seasonal employment during their academic breaks. Except for this material weakness, and the aforementioned material weakness in financial reporting of FSN after-employment benefits, the Secretary was able to provide assurance for the Department's internal controls in accordance with the Federal Managers' Financial Integrity Act.

We fully recognize that these and other items identified the Draft Audit Report will require our continued attention, action, and improvement. We look forward to working with you, Kearney & Company, and other stakeholders on addressing these issues in the coming year. We are committed to build on the progress made over the last few years to continue to execute a robust and meaningful external audit program in the most efficient and effective way possible. We appreciate everyone's effort toward this goal.

Thank you for the opportunity to comment on the Draft Report. I would also like to extend our thanks to your staff and Kearney & Company for the professional and collaborative manner in which they conducted the audit. Few outside the financial community likely realize the time and effort that go into producing the audit and the AFR, as we work to demonstrate our commitment to strong financial management and transparency.