Office of Inspector General

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United States Department of State
and the Broadcasting Board of Governors
Office of Inspector General

Office of Audits

Audit of Department of State Compliance With the Improper Payments Information Act

Report Number AUD/FM-12-31, March 2012

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PREFACE

This report was prepared by the Office of Inspector General (OIG) pursuant to the Inspector General Act of 1978, as amended, and Section 209 of the Foreign Service Act of 1980, as amended. It is one of a series of audit, inspection, investigative, and special reports prepared as part of OIG's responsibility to promote effective management, accountability and positive change in the Department of State and the Broadcasting Board of Governors.

This report addresses the Department of State's (Department) compliance with the Improper Payments Information Act of 2002, as amended by the Improper Payments Elimination and Recovery Act. The report is based on interviews with employees and officials of the Department, and a review of applicable documents.

OIG contracted with the external audit firm, Kearney & Company, P.C. (Kearney), to perform this audit. The contract required that Kearney perform its audit in accordance with guidance contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States. Kearney's report is included.

Kearney identified three areas in which improvements could be made: the risk assessment of improper payments, recapture audit activities, and improper payments reporting.

OIG evaluated the nature, extent, and timing of Kearney's work; monitored progress throughout the audit; reviewed Kearney's supporting documentation; evaluated key judgments; and performed other procedures as appropriate. OIG concurs with Kearney's findings, and the recommendations contained in the report were developed on the basis of the best knowledge available and were discussed in draft form with those individuals responsible for implementation. OIG's analysis of management's response to the recommendations has been incorporated into the report. OIG trusts that this report will result in more effective, efficient, and/or economical operations.

I express my appreciation to all of the individuals who contributed to the preparation of this report.

Harold W. Geisel
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Audit of Department of State Compliance with the Improper Payments Information Act

Office of Inspector General
U.S. Department of State
Washington, D.C.

Kearney & Company, P.C. (Kearney) has performed an audit of the Department of State's (Department) compliance with the Improper Payments Information Act of 2002, as amended by the Improper Payments Elimination and Recovery Act of 2010. Kearney evaluated the Department's performance in complying with the requirements set forth by the Office of Management and Budget. This performance audit, performed under Contract No. SAQMMA09D0002, was designed to meet the objective identified in the report section titled "Objective" and further defined in Appendix A, "Scope and Methodology."

Kearney conducted this performance audit from December 2011 through February 2012 in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. The purpose of this report is to communicate the results of Kearney's performance audit and its related findings and recommendations.

Kearney appreciates the cooperation provided by personnel in Department offices during the audit.

Kearney & Company

Kearney & Company, P.C.
Alexandria, Virginia
March 14, 2012

Acronyms

AFR	Agency Financial Report
BOC	budget object class code
Department	Department of State
GFMS	Global Financial Management System
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPIA	Improper Payments Information Act of 2002
Kearney	Kearney & Company, P.C.
OIG	Office of Inspector General
OMB	Office of Management and Budget
RFMS	Regional Financial Management System
RM	Bureau of Resource Management
RM/GFS/F/C	Global Financial Services, Global Financial Operations, Office of Claims
RM/GFS/OMA	Global Financial Services, Office of Oversight and Management Analysis

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Executive Summary

According to the Office of Management and Budget (OMB), the Federal Government makes billions of dollars in improper payments each year. Over the past decade, the Federal Government has implemented safeguards to reduce improper payments. In 2010, the Improper Payments Elimination and Recovery Act of 2010[1] (IPERA), which amended the Improper Payments Information Act of 2002[2] (IPIA), was signed into law. IPERA strengthened IPIA by increasing requirements for identifying and reporting on improper payments. In April 2011, OMB issued guidance to implement IPERA requirements.

IPERA requires agencies' Offices of Inspector General (OIG) to annually determine compliance with improper payments requirements.[3] In accordance with this requirement, Kearney & Company, P.C. (Kearney), an external audit firm acting on OIG's behalf, conducted this audit to determine whether the Department of State (Department) was in compliance with IPIA, as amended by IPERA.

Kearney found that the Department has taken steps to comply with IPIA. The Department performed a risk assessment of improper payments, implemented a recapture audit process, and included information on the risk assessment process and recapture audit activities in its FY 2011 Agency Financial Report (AFR).[4] However, Kearney found that the Department's improper payments risk assessment methodology was insufficient, recapture audit activities were not performed for all types of improper payments or all payments, and some improper payments disclosures required to be included in the AFR were omitted or were inaccurate. These deficiencies occurred primarily because of the lack of formal policies and procedures.

Management Comments

In its March 2012 draft of this report provided to the Department, OIG made three recommendations to enhance the Department's current controls and processes for preventing and promptly detecting and recovering improper payments and to help ensure compliance with Federal improper payments requirements. Specifically, OIG recommended that the Department develop policies and standardized procedures for performing improper payments risk assessments and recapture audit activities and for reporting information relating to improper payments in its AFR.

In its March 12, 2012, response (see Appendix B) to the draft report, the Department concurred "with the recommendations that the Department's existing risk assessments, recapture, and reporting activities for improper payments can be strengthened with added policies and procedures." The Department stated that it "has employed numerous preventative and

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[1] Pub. L. No. 111-204.
[2] Pub. L. No. 107-300.
[3] Pub. L. No. 111-204 § 3(b).
[4] Federal agencies may publish their financial statements in either an AFR or a Performance Accountability Report. The Department has elected to use the AFR format.

identification methods to support IPIA requirements" and is "committed to meeting" the requirements "in a reasoned manner."

Based on the Department's concurrence with the recommendations, OIG considers the three recommendations resolved. However, these recommendations will remain open until the Department provides documentation showing that it has taken actions to fully implement the recommendations.

Background

According to OMB, the Federal Government wastes billions of taxpayer dollars each year on improper payments to individuals, organizations, and contractors. Improper payments are payments that should not have been made or that were made in an incorrect amount. Improper payments include overpayments and underpayments, duplicate payments, payments made to an ineligible recipient, payments for an ineligible good or service, payments for goods or services not received (except for such payments authorized by law), payments that do not account for credit for applicable discounts, and payments for which an agency cannot determine whether the payments were proper because of insufficient or lack of supporting documentation.

Over the past decade, the Federal Government has implemented safeguards to reduce improper payments. IPIA, as initially enacted in 2002, required Federal agencies to annually identify programs and activities[5] at high risk of improper payments, estimate the amount of improper payments in those programs, perform recovery auditing if program payments exceeded $500 million, and report to Congress on steps taken to reduce improper payments.

Despite efforts to reduce improper payments, in FY 2010 agencies reported an estimated $125 billion in improper payments.[6] In July 2010, in an effort to further reduce improper payments, the President signed into law IPERA, an amendment to IPIA. IPERA clarified the programs to be reviewed, expanded payment recapture activities, and established compliance reviews and additional requirements for agencies that were deemed noncompliant.

In April 2011, OMB issued guidance for agencies implementing IPERA requirements, as Revised Parts I and II to Appendix C of OMB Circular A-123, *Management's Responsibility for Internal Control*. The guidance, among other things, defines the programs and payments that agencies must assess for the risk of improper payments and provides requirements for determining whether the risk of improper payments is significant, for developing an estimate of improper payments, for performing recapture audit activities, and for reporting improper payments activities.

Department of State Payments

The Department is the primary agency through which the U.S. Government conducts its diplomacy. The Department operates more than 270 embassies, consulates, and other posts

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[5] The term "program and activity" is referred to in this report as "program."

[6] U.S. Government Accountability Office, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges* (GAO -11-575T, April 15, 2011).

worldwide. The Department provides policy guidance, program management, administrative support, and in-depth expertise in areas such as law enforcement, economics, the environment, intelligence, arms control, human rights, counternarcotics, counterterrorism, public diplomacy, humanitarian assistance, security, nonproliferation, and consular services.

Because of the nature and the extent of its programs, the Department makes significant payments to third-party vendors, contractors, and grantees. During FY 2011, the Department reported approximately $30.1 billion in gross costs.[7] Of that amount, approximately $2.5 billion related to intragovernmental transactions and another $6.9 billion was for personnel costs, of which both amounts can be excluded from improper payments reviews.[8] The amount and volume of payments made by the Department, the Department's emphasis on expediting certain payments (for example, payments for necessary foreign financial assistance), and the decentralized nature of the Department's operations increase the Department's risk for improper payments.

The Department's Bureau of Resource Management (RM) has oversight responsibilities for the Department's financial management program. Financial management program responsibilities include establishing financial policy and procedure, financial reporting and analysis, management of financial information systems, and management controls. Management controls, also known as "internal controls," are the processes designed and implemented by an organization to help it accomplish its goals or objectives. Important internal control activities include those that are aimed at ensuring that only valid, proper payments are made.

The Department has internal controls in place to help prevent improper payments from occurring. For payments to vendors, vendors must submit invoices to either the Department's financial service centers or to the foreign post that procured the good or service. For an invoice to be paid, an approved official must certify that the good or service was received and ensure that the invoice is valid and accurate. Once the invoice is approved, two Department personnel, a voucher examiner and a certifying officer, are required to process the payment. The voucher examiner enters the transaction into the Department's accounting system and ensures that all supporting documentation has been submitted. The certifying officer reviews the transaction and verifies that the supporting documentation is complete and the accounting data is correct. The Department's financial accounting systems have automated controls that also verify certain payment-related information. For example, the domestic accounting system, the Global Financial Management System (GFMS), does not process payments with duplicate invoice numbers from one vendor. The Department uses other systems and processes to disburse payments for other activities (for example, grant payments or payments to pensioners). The Department has prepayment controls in place for these payments as well.

[7] Gross costs includes costs such as operating expenses, benefits, and depreciation.

[8] OMB Circular A-123, Appendix C, states that agencies may, but are not obligated to, review intragovernmental transactions and payments to employees for improper payments unless directed to do so by OMB.

Objective

The overall objective of this audit was to determine whether the Department was in compliance with IPIA, as amended by IPERA. To accomplish this objective, Kearney

- Evaluated whether the Department conducted a program-specific risk assessment for all programs.

- Evaluated the Department's performance in preventing, reducing, and recapturing improper payments.

- Reviewed the Department's FY 2011 AFR to determine whether the Department complied with reporting requirements.

Audit Results

A. Improper Payments Risk Assessment Methodology Was Insufficient

Risk assessments provide a baseline for establishing appropriate policies and selecting cost-effective techniques to implement these policies. The Department performed a risk assessment of improper payments in FY 2011. However, the Department's risk assessment methodology was insufficient. Specifically, the Department did not correctly apply the 2.5 percent improper payments rate threshold to determine risk susceptible programs, did not include all program costs in the programs reviewed, and did not consider all factors likely to contribute to improper payments. These deficiencies occurred because the Department had not developed policies and standard procedures for performing the risk assessments. As a result, the Department may not have identified all programs that were at risk of significant improper payments.

IPERA requires agencies to review all programs and identify those that are susceptible to significant improper payments. IPERA defines "significant" as improper payments in the program for the preceding fiscal year that may have exceeded (1) $10 million of all program payments made and 2.5 percent of program outlays or (2) $100 million. OMB Circular A-123, Appendix C, requires that agencies institute a systematic method of performing the reviews, also known as "risk assessments."

Kearney found that the Department performed a risk assessment of improper payments in FY 2011. The Department used a two-phased approach for its risk assessment. During the first phase, the Department assessed its controls over payments by grouping all expenses into six major payment categories: employee payments, travel payments, Federal financial assistance–grants, Federal financial assistance–international organizations payments, miscellaneous payments, and vendor payments. Based primarily on the Department's tests of controls performed during the OMB Circular A-123, Appendix A,[9] process and the absence of significant deficiencies identified during prior internal reviews and external audits, the Department concluded that employee payments, travel payments, and Federal financial assistance–grants were at low risk for being susceptible to significant improper payments. The risk for being susceptible to significant improper payments for the remaining three payment categories, Federal financial assistance–international organizations payments, miscellaneous payments, and vendor payments, was assessed during the second phase of the Department's risk assessment.

In the second phase, the Department reviewed its programs to identify those programs susceptible to significant improper payments. To identify programs and their related costs, the Department grouped its FY 2010 domestic expenses using a combination of the financial codes used to record transactions in GFMS–the function code and the budget object class code (BOC). According to the *Foreign Affairs Handbook* (FAH),[10] function codes show the purpose of the payment and are used to meet the Department's requirements for identifying and classifying the

[9] Appendix A in OMB Circular A-123 provides a methodology for agency management to assess, document, and report on internal controls over financial reporting. This effort is separate from the improper payments requirements in Appendix C.

[10] 4 FAH-1 H-511(7) and 4 FAH-1 H-512 b(1).

programs under the Department's appropriations. For example, the Department has function codes for activities such as Arms Control and the Africa Refugee Program. BOCs identify the kind of services, materials, and other resources for which payments are made.[11] For example, the Department uses BOCs for items such as voluntary contributions and contractor security guard payments. The Department identified each group of expenses with the same function code and BOC combination as a program.

To determine which of its programs were susceptible to significant improper payments, the Department calculated an improper payments threshold by applying the 2.5 percent rate in IPERA to the Department's total FY 2010 costs of $27.5 billion. Only four programs, those listed in Table 1, had expenses that met or exceeded the Department's threshold of $687.55 million.

Table 1. Programs Meeting the Department's Improper Payments Threshold

Program	FY 2010 Program Expenses (in millions)
Construction	$903.1
Retirement	$836.4
African Union-United Nations Hybrid Mission in Darfur	$763.4
Near East Refugee Program	$741.6

Source: Department IPIA risk assessment documentation.

The Department assessed each of these four programs for the risk of improper payments. The assessment considered some qualitative factors, such as payment calculation complexity, the monitoring procedures in place, and a determination as to whether internal control material weaknesses or deficiencies that could increase improper payments had been identified in the program. However, a primary consideration in the second phase of the assessment was the Department's $687.55 million threshold. The Department's risk assessment documentation states that, based on the threshold, "between 76% - 92% of all payments made within those programs would have to be in error to trigger required reporting." The Department concluded that "the risk of those four programs being susceptible to making significant improper payments (i.e., having errors exceeding 76% of the total program)" was very low.

Although the Department performed a risk assessment of improper payments, the risk assessment methodology it used was insufficient. Specifically, the Department did not correctly apply the 2.5 percent improper payments rate threshold for identifying risk susceptible programs and, as a result, did not review all of its programs. In addition, the Department did not include all program costs in the programs it reviewed, and the Department's risk assessment did not consider all factors likely to contribute to improper payments.

Improper Payments Threshold

OMB Circular A-123, Appendix C, states that significant improper payments are gross annual improper payments <u>in the program</u> exceeding (1) both 2.5 percent <u>of program outlays</u> and $10 million of <u>all program payments</u> made or (2) $100 million. The Circular defines the term

[11] 4 FAH-1 H-611.

"program" to include "activities or sets of activities recognized as programs by the public, OMB, or Congress, as well as those that entail program management or policy direction." Programs include, but are not limited to, all grants, regulatory activities, research and development activities, direct Federal programs, all types of procurements, credit programs, and the activities engaged in by the agency in support of its programs.

The Department did not correctly apply the 2.5 percent improper payments rate threshold to determine risk susceptible programs. It applied the 2.5 percent threshold against total agency costs instead of the costs of each program, as was required. The Department's misinterpretation of the threshold requirement inflated the amount of improper payments necessary for a program to be at risk. The amounts of significant improper payments for the four identified programs using the 2.5 percent rate threshold for each program compared with the threshold calculated by the Department are shown in Table 2.

Table 2. Comparison of Improper Payments Amounts Using Program Expenses and Total Costs

Program	FY 2010 Program Expenses (in millions)	Amount of Significant Improper Payments	
		2.5% of Program Expenses (in millions)	2.5% of Total Department Costs (in millions)
Construction	$903.1	$22.58	$687.55
Retirement	$836.4	$20.91	$687.55
African Union-United Nations Hybrid Mission in Darfur	$763.4	$19.08	$687.55
Near East Refugee Program	$741.6	$18.54	$687.55

Source: Kearney prepared based on the Department's IPIA risk assessment documentation.

As shown in Table 2, all four programs met the requirements for programs that could be susceptible to significant improper payments. In addition, had the Department correctly applied the 2.5 percent rate threshold to all programs, the Department would have identified additional programs requiring further risk assessment. For example, the Department's Ambassadors-at-Large program had FY 2010 expenses amounting to $558.7 million. This program met the IPERA threshold, but it was not identified as a potentially risk susceptible program by the Department.

Program Costs

Although OMB Circular A-123, Appendix C, states that an agency is not obligated to include intragovernmental transactions and payments to employees in its improper payments reviews, the circular does not identify any other types of payments that may be excluded. All program costs should be identified in order for the Department to accurately calculate the improper payments rate threshold for each program.

The Department did not include all program costs in the programs reviewed. Grouping its expenses by function code enabled the Department to identify and review some of its larger programs. However, this methodology captured only program costs with specific function code and BOC combinations. Although each program, or function code, may have expenses relating to multiple BOCs, the Department did not aggregate all BOCs for the same function code. For example, the majority of FY 2010 costs for the Near East Refugee Program were disbursed between two BOCs, Voluntary Contributions and Cooperative Agreements. Individually, expenses categorized as Voluntary Contributions totaled $741.6 million and Cooperative Agreements totaled $55.8 million. Aggregated programs costs exceeded $797 million, but all costs were not considered during the second phase of the risk assessment.

Qualitative Factors

OMB Circular A-123, Appendix C, states that an agency can consider risk factors likely to contribute to significant improper payments as part of its systematic method of reviewing programs. At a minimum, these risk factors should include the following: whether the program is new; the complexity of the program, particularly with respect to determining correct payment amounts; the volume of program payments made annually; whether payments or payment eligibility decisions are made outside the agency; recent major changes in program funding or practices; the level, experience, and quality of training for personnel making program eligibility determinations or certifying that payments are accurate; significant deficiencies in audit reports; and results from prior improper payments work.

The Department considered some but not all of these qualitative factors during its risk assessment. The Department did not take into account all risk factors likely to contribute to significant improper payments. For example, the risk assessment for the four programs that the Department reviewed did not include a consideration of whether the program was new to the agency; the volume of payments made annually; recent major changes in program funding, authorities, practices, or procedures; or the level, experience, and quality of training for personnel responsible for certifying that payments are accurate.

Further, although not specifically required by IPERA or OMB, Kearney noted that the Department did not obtain input for the risk assessment from bureaus or offices other than RM. Bureau program personnel are the best source for information about their programs and associated risks. Without input from program managers, RM may not be aware of factors that could increase or decrease a program's risk, such as the complexity of the program; unique contractual requirements; or the existence, or lack of, program-specific controls. In addition, if these sources are not consulted during the risk assessment process, RM may not become aware of significant changes in the program, and the use of outdated or inaccurate information may lead to an incorrect assessment of program risk.

The deficiencies in the Department's risk assessment methodology occurred primarily because the Department did not develop policies and standard procedures for performing the risk assessment. Specifically, the Department did not develop a comprehensive definition of what constitutes a Department program, a process to align all costs to the programs, and policies and procedures for assessing each program's risks that included the consideration of all relevant qualitative factors and input from bureau program managers.

By not developing and performing a sufficient risk assessment, the Department may not have identified all programs with the risk of significant improper payments. Therefore, the Department could not determine whether its improper payments were significant enough to require corrective action. A risk assessment is the starting point for any successful improper payments reduction and recapture program. The information developed during a risk assessment forms the foundation upon which management can determine the nature and type of controls in place and identify control improvements to reduce risks and ultimately improper payments.

Recommendation 1. OIG recommends that the Bureau of Resource Management develop policies and standard procedures for performing an improper payments risk assessment. The policies and procedures should include, but not be limited to, the following:

- A comprehensive definition of the programs to be assessed.
- A method to ensure that all program costs are identified.
- A description of the quantitative and qualitative factors to be considered.
- A method to obtain input from the bureaus and offices responsible for the programs.

Department Response: The Department concurred that the Department's existing risk assessments "can be strengthened with added policies and procedures."

OIG Reply: OIG considers the recommendation resolved, pending further action. This recommendation can be closed pending OIG's review and acceptance of the Department's policies and procedures for performing an improper payments risk assessment.

B. Recapture Audit Activities Were Not Performed for All Types of Improper Payments or All Payments

Payment recapture audits are detective or corrective control activities designed to assist management in identifying and recapturing overpayments. The Department implemented a recapture audit process that, in conjunction with its routine post-payment reviews, identified and recovered improper vendor payments totaling over $45 million since FY 2007. However, the Department limited its recapture audits to one type of improper payments and excluded a significant amount of payments from the audits. The Department did not perform and document cost-benefit analyses to support the exclusions and did not inform OMB or OIG. In addition, the recapture audit process was focused on payments alone without a consideration of program factors that may have increased or decreased the risk of improper payments. As a result, the Department may not have identified and recovered all improper payments.

IPERA requires agencies to conduct recovery audits (also known as "recapture audits") if conducting such audits would be cost effective. According to OMB Circular A-123, Appendix

C, a recapture audit is a review and analysis of accounting and financial records, supporting documentation, and other information supporting payments that is specifically designed to identify overpayments.

Kearney found that the Department had implemented a recapture audit process. RM's Global Financial Services, Office of Oversight and Management Analysis[12] (RM/GFS/OMA), performs the Department's recapture audit activities. RM/GFS/OMA uses IDEA, a data analysis tool, to audit domestic payments on a monthly basis. RM/GFS/OMA extracts a data file of payments made during the previous month from GFMS and imports the file into IDEA. IDEA performs a search for potential duplicate payments by comparing the invoice number and dollar amount of each payment in the monthly data file against the payments made during the previous 3 years. Payments with the same invoice number and dollar amount are extracted into a separate file of potential duplicate payments. RM/GFS/OMA provides the potential duplicate payments to the Global Financial Operations, Office of Claims[13] (RM/GFS/F/C), for review. Through this process, RM/GFS/OMA identified $567,336 in actual duplicate payments made during FY 2011. Of this amount, $567,014 was recaptured.

In addition to the recapture audit activities performed by RM/GFS/OMA, RM/GFS/F/C performed post-payment review activities. For example, RM/GFS/F/C selects random samples of payments on a monthly basis and reviews the sampled items for adequate support, proper approval, and the validity and accuracy of the amounts disbursed. RM/GFS/F/C also uses data-matching techniques similar to the recapture audit activities to identify potential duplicate payments. The Department considers these post-payment reviews a part of the routine payment process. As required by OMB Circular A-136, as revised, *Financial Reporting Requirements*, the amounts identified and recovered during these reviews are reported as improper payments recoveries outside the scope of recapture audits. During FY 2011, RM/GFS/F/C identified $15.6 million in overpayments through its post-payment reviews, of which the Department recovered $14.4 million.

Together, the Department's post-payment reviews and recapture audits identified improper vendor payments totaling approximately $49.4 million from FYs 2007–2011. Of that amount, the Department recovered approximately $45.9 million, as shown in Table 3.

Table 3. Improper Payments Identified and Recovered From FYs 2007–2011

FY	Amount Identified (in millions)	Amounts Recovered (in FY) (in millions)
2011	$16.6	$15
2010	8.1	7.9
2009	3.9	3.8
2008	15.4	14.3
2007	5.4	4.9
Total	**$49.4**	**$45.9**

Source: Department AFRs from FYs 2007–2011.

[12] RM/GFS/OMA is responsible for, among other things, ensuring compliance with financial laws, policies, and procedures and performing internal control and quality control reviews.
[13] RM/GFS/F/C is the central domestic funding paying agent of the Department.

Although the Department performed recapture audits, the audits were limited to one type of improper payments–duplicate payments. In addition, the Department excluded a significant amount of payments from the recapture audits. However, the Department did not conduct and document costs-benefit analyses to support these exclusions or inform OMB and OIG of the exclusions, as was required. In addition, the Department focused its recapture audits on payments rather than programs, which limited the Department's ability to target recapture activities on the highest risk programs.

Recapture Audit Exclusions

OMB Circular A-123, Appendix C, states that agencies may exclude payments from certain programs from payment recapture audit activities if the agency determines that payment recapture audits are not a cost-effective method for identifying and recapturing improper payments. If an agency excludes a program that expends more than $1 million, the agency must notify OMB and OIG of this decision and include any analysis used by the agency to reach this decision.

Kearney found that the Department's recapture audits were limited to a search for duplicate payments. The audits did not search for other types of improper payments. For example, the audits were not designed to identify overpayments or underpayments and were not designed to identify payments for goods and services not received, payments to ineligible recipients, fraudulent payments, or payments that lacked adequate support.

Kearney also found that the Department's FY 2011 recapture audit process did not include a significant amount of payments. Specifically, the Department excluded, from payment recapture audits, the payments that were made outside the RM/GFS/F/C payment process. For example, the Department excluded overseas payments amounting to about $2.6 billion. These payments were processed by the Regional Financial Management System (RFMS), the Department's overseas financial system, rather than GFMS. The Department also excluded grant payments amounting to about $3.0 billion that were made through the Payment Management System,[14] which processes the majority of the Department's financial assistance-related payments. In addition, the Department excluded pension annuity payments amounting to about $671 million that were processed by RM's Retirement Accounts Division. The Department excluded these payments for a variety of operational reasons. For example, RFMS does not require that the invoice number, which is used by RM/GFS/OMA to identify duplicate payments, be entered for overseas payments, and in some cases, multiple invoices may be entered and the payments may be made with one disbursement.

The Department also excluded certain payments that were processed by RM/GFS/F/C from the recapture audits. The excluded payments included, but were not limited to, bulk payments, which included purchase card payments, shipping payments, and certain travel payments. These bulk payment exclusions exceeded $250 million in FY 2011.

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[14] The Payment Management System is a grant payment system maintained by the U.S. Department of Health and Human Services.

As a result of the exclusions, the Department's FY 2011 recapture audit activities covered $9.5 billion, or about 86 percent, of the $11 billion in payments processed by RM/GFS/F/C and only about 46 percent of the Department's FY 2011 expenses subject to IPERA reviews of approximately $20.7 billion. Although it excluded a significant amount of payments, the Department did not perform and document a cost-benefit analysis supporting the basis for these exclusions, as was required. In addition, the Department did not notify OMB and OIG of the exclusions.

Recapture Audit Focus

IPERA requires agencies to conduct payment recapture audits for each program that expends $1 million or more annually if conducting such audits would be cost effective. OMB Circular A-123, Appendix C, requires all programs exceeding the $1 million threshold, including grant, benefit, loan, and contract programs, to be considered during the payment recapture audits. Agencies are required to review their different types of programs and prioritize conducting payment recapture audits on those categories that have a higher potential for overpayments and recoveries.

Kearney found that the Department's recapture audits focused on payments rather than on programs. The Department's approach enabled it to include a large number of payments in the recapture audits. Although performing recapture audit activities based on payments is a beneficial internal control, using a payment approach alone does not consider specific program characteristics that may increase or decrease the risk for improper payments. For example, payments made for programs that have a large number of disbursements and limited oversight resources, such as programs in war zones or at some hardship posts, received the same level of review as payments for programs that have a small number of disbursements and adequate resources. In addition, although the amount of improper payments identified during recapture audits may appear to be insignificant to the Department as a whole using the payment approach, the amount of improper payments identified for a specific program may be significant to the program. A more program-focused approach would enable the Department to identify the programs that have a high rate of improper payments, target future recapture audit activities more efficiently on those programs, and identify and correct the circumstances that led to improper payments in those programs.

The deficiencies identified in the Department's recapture audit program occurred primarily because the Department had not developed policies and standard procedures for performing recapture audits that included identifying the programs and payments to be audited; for obtaining the information necessary for the audits from sources outside RM/GFS/F/C; for performing cost-benefit analyses to identify programs or payments to be excluded; and, if programs or payments are excluded, for making the appropriate notifications to OMB and OIG.

Without a sufficient, cost-effective recapture audit program, the Department may have made but may not have identified and recovered all improper payments. A well-designed recapture audit process targets areas most susceptible to improper payments and leverages the latest technologies. Although traditionally used as a technique to identify improper payments already made, recapture auditing results can also be used to identify trends in improper payments and improve controls to prevent improper payments.

Recommendation 2. OIG recommends that the Bureau of Resource Management develop policies and standard procedures for its recapture audit activities. These policies and procedures should include, but not be limited to, the following:

- Program, as well as payment, audit activities to help target recapture audits on programs or payment types that are deemed higher risk.
- Alternative procedures to audit payments occurring outside the Global Financial Management System.
- Analytics and other proven recapture audit techniques (for example, predictive modeling, additional forensic accounting tools, additional data matches, and financial incentives) that address improper payments types other than duplicate payments.
- Requirements for performing a cost-benefit analysis for programs and payment types excluded from recapture audit activities and communicating the exclusions to the Office of Management and Budget and OIG.

Department Response: The Department concurred that the Department's existing recapture activities "can be strengthened with added policies and procedures."

OIG Reply: OIG considers the recommendation resolved, pending further action. This recommendation can be closed pending OIG's review and acceptance of the Department's policies and procedures for recapture audit activities.

C. Required Improper Payments Disclosures in the FY 2011 Agency Financial Report Were Omitted or Were Inaccurate

AFRs play a significant role in fulfilling the Government's duty to be accountable and can be used to assess an agency's efficiency and effectiveness in performing activities such as identifying and recapturing improper payments. The Department's FY 2011 AFR included information that provided a high-level understanding of the Department's IPIA process and recapture audit results. However, the AFR did not include all required disclosures, and some information included in the AFR was inaccurate. By not including complete and accurate information in its AFR, the Department is not providing users with relevant and reliable information about its efforts related to improper payments.

IPERA states that for an agency to be in compliance with IPIA, the agency must publish an annual financial statement for the most recent fiscal year and post that report, with the information on improper payments required by OMB, on the agency's Web site. OMB Circular A-123, Appendix C, requires an agency to disclose specific information relating to improper payments in its annual AFR in the format provided in OMB Circular A-136.

The Department published its FY 2011 AFR on its Web site. The AFR included certain improper payments disclosures. For example, the AFR included summary information on improper payments, a general description of the Department's risk assessment process, and a description of the Department's payment recapture audit program. The information reported in the AFR provided a high-level of understanding of the Department's IPIA processes and the recapture audit results achieved.

Although the Department included some of the required disclosures in its AFR, Kearney identified several disclosures that were omitted by the Department. For example, OMB Circular A-136 requires that an agency provide a brief description of its progress on eliminating and recovering improper payments in the Management's Discussion and Analysis section of its AFR. OMB Circular A-123, Appendix C, requires that an agency report the basis for its groupings of programs in the AFR and provide a description and justification of the classes of payments excluded from payment recapture audits as well as an explanation of why recapture audits were not performed on all programs, including those programs in which an agency has determined that a payment recapture audit program is not cost effective. The Department did not make these disclosures in its FY 2011 AFR.

In addition, the Department's payment recapture tables in the AFR did not follow the format provided in OMB Circular A-136, and the Department did not include all required information in the tables. Specifically, the tables did not include columns to identify the programs for which recapture audits were performed, as was required. Further, the recapture tables did not include complete information on the payments identified and recovered through sources other than payment recapture audits. The Department included the amounts identified and recovered by RM/GFS/OMA during recapture audit activities and RM/GFS/F/C during post-payment reviews. However, the Department did not include information on payments identified and recovered in other Department offices and bureaus, such as OIG recoveries, contract close-out recoveries, recoveries resulting from grant compliance reviews, and pension overpayment recoveries.

Kearney also identified some information in the AFR that was inaccurate. In its description of the recapture audit analysis, the Department states that the domestic payment file used during the analysis "presently includes the majority of payments subject to IPERA requirements such as most domestic vendor payments and grant payments." However, the Department did not include grant payments made through the Payment Management System in its recapture audits, and these payments make up the majority of grant payments made by the Department. Further, the recapture tables include a column for identifying the type of payment included in the payment recapture audit. In the Department's payment recapture tables, this column indicated that all payments were subject to the review. However, as discussed in Finding B, the Department excluded, from its payment recapture audits, certain payment types, including overseas payments, Payment Management System payments, pension annuity payments, and bulk payments.

Although the Department had informal processes for preparing the improper payments disclosures for its AFR, it had not developed policies and standard procedures for preparing the disclosures and ensuring their completeness and accuracy.

By not including all required information in its AFR, the Department did not provide users with relevant and reliable information about its efforts to prevent and identify and recover improper payments. AFRs play a key role in fulfilling the Government's duty to be accountable for the use of public funds, and AFRs can be used to assess an agency's efficiency and effectiveness in performing activities such as identifying and recapturing improper payments. The results of an agency's actions related to improper payments should be available not only to Congress and agency management but also to the general public.

Recommendation 3. OIG recommends that the Bureau of Resource Management develop policies and standard procedures that ensure that the improper payments information included in the Department of State Agency Financial Report is complete and accurate.

Department Response: The Department concurred that the Department's existing reporting activities "can be strengthened with added policies and procedures."

OIG Reply: OIG considers the recommendation resolved, pending further action. This recommendation can be closed pending OIG's review and acceptance of the Department's policies and procedures for reporting improper payments information in the AFR.

List of Recommendations

Recommendation 1. OIG recommends that the Bureau of Resource Management develop policies and standard procedures for performing an improper payments risk assessment. The policies and procedures should include, but not be limited to, the following:

- A comprehensive definition of the programs to be assessed.
- A method to ensure that all program costs are identified.
- A description of the quantitative and qualitative factors to be considered.
- A method to obtain input from the bureaus and offices responsible for the programs.

Recommendation 2. OIG recommends that the Bureau of Resource Management develop policies and standard procedures for its recapture audit activities. These policies and procedures should include, but not be limited to, the following:

- Program, as well as payment, audit activities to help target recapture audits on programs or payment types that are deemed higher risk.
- Alternative procedures to audit payments occurring outside the Global Financial Management System.
- Analytics and other proven recapture audit techniques (for example, predictive modeling, additional forensic accounting tools, additional data matches, and financial incentives) that address improper payments types other than duplicate payments.
- Requirements for performing a cost-benefit analysis for programs and payment types excluded from recapture audit activities and communicating the exclusions to the Office of Management and Budget and OIG.

Recommendation 3. OIG recommends that the Bureau of Resource Management develop policies and standard procedures that ensure that the improper payments information included in the Department of State Agency Financial Report is complete and accurate.

Appendix A

Scope and Methodology

The Improper Payments Elimination and Recovery Act of 2010[1] (IPERA), which amends the Improper Payments Information Act of 2002[2] (IPIA), requires the Office of Inspector General (OIG) to conduct an annual audit of the Department of State's (Department) compliance with improper payments requirements. In accordance with the IPERA requirement, an external audit firm, Kearney & Company, P.C. (Kearney), acting on OIG's behalf, performed this audit to determine whether the Department was in compliance with IPIA, as amended by IPERA.

Kearney conducted this performance audit from December 2011 through February 2012 in Washington, D.C., and at the Office of Global Financial Services in Charleston, South Carolina. Kearney planned and performed the audit in accordance with performance audit requirements in the Government Accountability Office's *Government Auditing Standards*, July 2007 Revision. Those standards required that Kearney obtain sufficient, appropriate evidence to provide a reasonable basis for findings and conclusions. The sufficiency and appropriateness of evidence needed and tests of evidence related directly to the objective and scope of the audit.

Kearney focused the scope of the audit on the following objectives: (1) evaluation of the accuracy and completeness of the Department's improper payments risk assessment process; (2) evaluation of the Department's performance in preventing, reducing, and recapturing improper payments; and (3) reviewing the Department's FY 2011 Agency Financial Report (AFR) to determine whether the agency complied with requirements.

Kearney designed the audit to obtain insight into the Department's current processes, procedures, and organizational structure with regard to compliance with IPIA requirements. To expedite the audit process, Kearney leveraged the results of its FY 2011 financial statement audit of the Department to confirm its understanding of the nature and profile of Department operations, IPIA standards, regulatory requirements, and supporting information systems and controls.

Kearney conducted process walkthroughs and interviews with Department officials to obtain a sufficient understanding of the steps taken by the Department to assess the risk of improper payments; its process of identifying significant improper payments; the steps taken to prevent, reduce, and recapture improper payments; and the process of reporting improper payments. Consistent with the fieldwork standards for performance audits, Kearney established performance criteria and identified sources of audit evidence to complete the testing phase.

The testing phase provided Kearney with evidence to determine the findings of the report issued for the performance audit. The criteria determined in the planning phase served as the bases for assessing the Department's compliance with IPIA requirements. The testing phase included procedures to assess the Department's IPIA reporting process, the recapture audit process, and the AFR disclosures.

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[1] Pub. L. No. 111-204 §3(b).
[2] Pub. L. No. 107-300.

During the reporting phase, Kearney formally communicated the conclusions reached and the findings and recommendations for the actions the Department should take to comply with IPIA requirements.

Appendix B

United States Department of State

Chief Financial Officer

Washington, D.C. 20520

MAR 12 2012

UNCLASSIFIED
MEMORANDUM

TO: OIG – Harold W. Geisel

FROM: RM – James L. Millette

SUBJECT: Draft Report on Audit of Department of State Compliance With the Improper Payments Information Act

Thank you for the opportunity to comment on the Office of Inspector General's (OIG) Draft Report on the Department of State Compliance with the Improper Payments Information Act (IPIA) for FY 2011.

This compliance audit represents a new layer of required reporting to OMB and Congress for FY 2011. The associated IPIA regulatory guidance was formally released in April 2011 and OMB revision of Circular No. A-136, which provides financial reporting requirements, was released on October 27, 2011, after fiscal year-end. Although recently issued, the Department has made significant efforts to comply with all guidance in a manner that also leverages the good stewardship of government funds and ensures our initiatives are cost-effective. While we may not agree on all aspects of the report, we concur with the recommendations that the Department's existing risk assessments, recapture, and reporting activities for improper payments can be strengthened with added policies and procedures

As acknowledged in the Draft Report, the Department has employed numerous preventative and identification methods to support IPIA requirements. We have dedicated considerable resources to prevent improper payments from occurring, and take pride in our track record of success based on the low volume of actual improper payments identified and recovered each year. Prior IPIA regulatory guidance was geared toward high-risk programs and activities that were deemed susceptible to significant improper payments. Despite having no programs or activities susceptible to significant improper payments, as previously defined, the Department used risk assessment and recapture initiatives to assist in identifying improper payments and related payment issues. In addition, with the implementation of our Global Financial Management System in 2007, we fully integrated acquisitions into the financial system at the line level, significantly enhancing the integrity of our payments.

We recognize that the IPERA and related guidance has raised the bar on transparently accounting for and preventing improper payments for all Agencies, including the Department. We are committed to meeting these compliance requirements in a reasoned manner. We look forward to working with both the OIG and the Independent Auditor on further enhancements to our existing IPIA and IPERA programs in the coming year.