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MANAGEMENT LETTER
AUD-FM-15-08

To the Chief Financial Officer and Inspector General of the U.S. Department of State:

Kearney & Company, P.C. (referred to as "we" hereafter), has audited the consolidated financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2014, and has issued our report thereon dated November 15, 2014.[1] In planning and performing our audit of the Department's consolidated financial statements, we considered the Department's internal control over financial reporting and the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements. Our auditing procedures were designed for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurances on internal control or compliance. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting or on the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements.

During our audit, we noted certain matters related to internal control over financial reporting that we considered to be significant deficiencies and certain matters relating to compliance that we considered to be reportable under 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 Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements.* These items are not repeated in this letter, as they are explained in detail in our report on the Department's FY 2014 financial statements.

Our procedures were designed primarily to enable us to form an opinion on the Department's consolidated financial statements and therefore may not have identified all internal control weaknesses and instances of noncompliance that may exist. Although not considered to be material weaknesses, significant deficiencies, or reportable instances of noncompliance, we noted certain other matters involving internal control, operations, and compliance. These findings and recommendations, which are summarized in Appendix A, are intended to assist the Department in strengthening internal controls and improving operating efficiencies.

We appreciate the courteous and professional assistance provided by Department personnel during our audit. These findings and recommendations have been discussed with appropriate Department officials. Department management did not have formal comments on this letter.

[1] *Independent Auditor's Report on the U. S. Department of State 2014 and 2013 Financial Statements* (AUD-FM-15-07, Nov. 2014).

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

Kearney & Company

Alexandria, Virginia
February 25, 2015

MANAGEMENT LETTER COMMENTS

REPEATED FROM PRIOR YEAR

During the audit of the U.S. Department of State's (Department) FY 2013 financial statements, Kearney & Company, P.C. (referred to as "we" hereafter), identified matters that were reported in a management letter.[1] During the audit of the FY 2014 financial statements, we assessed the status of the deficiencies reported during FY 2013. The severity of one issue included in the FY 2013 management letter related to improvements to domestic leased property decreased, and we considered the item closed. Nine issues remained open and were updated with information obtained during the audit of the Department's FY 2014 financial statements.

I. Foreign Service National After-Employment Benefits

Inaccurate Personnel Data for Foreign Service National Employees

The Department's workforce includes Civil Service, Foreign Service, and Foreign Service National (FSN) employees. FSN employees are generally paid in local currency, and their salary and benefits are based on local prevailing practice, which is documented in each post's local compensation plan. Human resource information for FSNs, such as date hired, transfers, grade increases, and date of separation, is maintained in the Department's WebPass application. When a personnel action is initiated for an FSN, the post enters the information into WebPass. The FSN personnel information is then submitted to a Global Financial Service Center (GFSC) where officials manually enter the information into the FSN Payroll (FSNPay) application or the Global Foreign Affairs Compensation System (GFACS).[2]

We assessed the completeness of employee information in WebPass, FSNPay, and GFACS for all overseas posts that provide voluntary severance or supplemental lump sum after-employment benefits. We used automated audit techniques to compare the total number of employees and the names of individuals in WebPass, FSNPay, and GFACS. Table 1 shows the results of our testing for FY 2014, as well as the results of our testing from FY 2013 for comparative purposes.

[1] *Management Letter Related to the Audit of the U.S. Department of State FY 2013 Financial Statements* (AUD/FM-14-11, Mar. 2014).

[2] The Department began implementing GFACS on a post-by-post basis in FY 2013 with the intent to convert all posts from FSNPay to GFACS by June 2015.

Table 1: Total Number of Individuals in the Payroll Applications and WebPass

Individuals Reviewed	FY 2014	FY 2013
Individuals in both WebPass and the applicable payroll application	23,161	22,388
Individuals in WebPass that were not in the applicable payroll application	347	248
Individuals in a payroll application that were not in WebPass	258	280

For the employees included in both systems, we performed additional testing to identify data inconsistencies related to the date of birth, service computation date, and annual salary fields. Table 2 shows the results of our testing for FY 2014, as well as the results of our testing from FY 2013 for comparative purposes.

Table 2: Data Inconsistencies Between the Payroll Applications and WebPass

Inconsistency Identified	FY 2014	FY 2013
Employee's date of birth was not consistent	736	843
Employee's service computation date was not consistent	2,751	2,644
Employee's annual salary was not consistent	2,447	2,662

The Department tested a judgmental sample of the discrepancies we noted and reported that WebPass contained more accurate information on employees' dates of birth and service computation dates, and FSNPay or GFACS contained more accurate salary information. We re-performed the Department's testing and confirmed its conclusions regarding the most accurate sources of FSN employee information.

We found that posts were processing personnel actions inconsistently. In certain instances, posts were not notifying the responsible GFSC in a timely manner about personnel actions that had been processed. Additionally, we noted instances where data submitted to the responsible GFSC was not updated in the applicable payroll application to reflect changes made in WebPass. We also found instances where approved personnel actions were not accurately entered into the applicable payroll application once the information was provided to the GFSC due to data entry error. The Department did not have a control in place to ensure that all post-approved personnel actions included in WebPass were also entered into either FSNPay or GFACS, such as a process to regularly reconcile the data between the applications.

The Department estimates a liability to include in its financial statements for after-employment benefits offered to some FSNs. The reasonableness of the liability estimate related to after-employment benefits relies on accurate underlying employee demographic data. Without accurate and complete FSN personnel data, the Department may not be able to efficiently or accurately calculate its annual liability for after-employment benefits. The Department was able to adjust its liability estimation methodology to address the discrepancies identified during our testing through manual manipulation of data in either FSNPay or GFACS and WebPass. These manual calculations required additional time and effort and were more prone to inaccuracies.

In addition, the risk of improper payments exists if personnel actions are not processed properly or timely or when payroll and benefit payments are calculated based on inaccurate data. The lack of reconciliation between the payroll applications and WebPass may result in errors and inconsistencies remaining undetected and uncorrected for long periods of time.

This issue was initially reported in our FY 2012 report on internal control.

Recommendation:

We recommend that the Department:

- Standardize requirements for processing personnel actions at posts to include deadlines for submitting information to the responsible Global Financial Service Center.
- Periodically perform reconciliations between WebPass and the payroll applications to identify data discrepancies.
- Refine the process used to calculate the Foreign Service National after-employment liability estimate based on the results of any data remediation or validation efforts.

Insufficient Inventory of Foreign Service National After-Employment Benefits

The Department provides some FSN employees with after-employment benefits through a variety of arrangements, including annuity-based defined benefit retirement plans, defined contribution retirement plans, lump-sum retirement payments, post-retirement health benefits, and separation benefits to FSNs who voluntarily resign or otherwise leave the workplace. These benefits are detailed in each post's Local Compensation Plan (LCP), which governs the Human Resource policies of each post. The Department estimates liabilities relating to FSN after-employment benefits for financial reporting purposes.

We performed tests to assess the completeness of the Department's centralized inventory of FSN after-employment benefit plans. At one of five overseas posts included in our testing, we identified a post-retirement health benefit that was not included in the Department's inventory.

We also assessed the responses to a questionnaire that the Department sent to overseas posts requesting information on FSN after-employment benefits and noted additional changes that needed to be made to the Department's inventory of benefits. Specifically, the following benefits had not been identified in prior years or included in the inventory:

- Post-retirement health benefits at nine posts.
- Lump-sum retirement benefits or voluntary separation benefits at two posts.
- Defined contribution plans at 10 posts.

The Department lacked formalized routine processes to inventory, monitor, and account for FSN benefit plans. The existing inventory of benefit plans was based on plans listed in each post's LCP, plans identified by us or the Department during overseas visits, and plans communicated by posts to the Department in response to previous FSN after-employment benefit questionnaires. We found that the posts' LCPs did not always include all benefits offered by posts and some LCPs were outdated. We also identified instances where benefit plan provisions were not documented in a clear and complete manner in the LCP. In addition, responses to FSN after-employment benefit questionnaires were not always received in a complete and understandable manner. For example, we noted responses that directly contradicted information in the post's LCP.

An inaccurate inventory of FSN benefit plans may lead to future funding shortfalls and financial reporting inaccuracies. As new benefits are identified, the Department must develop a method to quantify whether the impact of the benefit plan is material to the overall financial statements, which can be time consuming and resource intensive. Consequently, the nuances of benefit plans may be misinterpreted in the Department's estimation models and assumptions. Further, budgeting and financial planning decisions may be made without a complete understanding of the short- and long-term obligations relating to all existing FSN benefit plans.

Issues relating to the Department's inventory of FSN After-Employment Benefits were initially reported in our FY 2011 report on internal control.

Recommendation:

We recommend that the Department:

- Document and formalize its processes to inventory and monitor Foreign Service National after-employment benefits.
- Continue to perform reviews and analyses to ensure that each Local Compensation Plan is current, complete, and understandable.
- Continue to confirm and validate its inventory of Foreign Service National after-employment benefits offered.

II. General Issue

Untimely Responses to Audit Requests

As part of the financial statement audit, we made requests for data and documentation in order to validate and substantiate account balances and transactions that support the Department's financial statements. In general, the data we requested should have been an integral component of the Department's internal control structure and therefore should have been readily available.

The Department did not always provide documentation in a timely manner. As of November 4, 2014, we had issued 762 audit requests with due dates prior to November 4, 2014. Of 762 requests, we received complete responses to 749 requests by November 4, 2014. Of 749 responses received, 549 items were provided by their agreed-upon due dates (73 percent). Table 3 provides an overall summary of the response times for the 749 items.

Table 3: Response Times for Audit Requests

	Total Items Received as 11/04/2014	Received by Due Date	Received One Week or Less After Due Date*	Received Between One and Two Weeks After Due Date*	Received Between Two and Three Weeks After Due Date*	Received More Than Three Weeks After Due Date*
Audit Requests	749	549	126	20	21	33

*We considered one week to be five business days.

The number of items that were provided in a timely manner improved in FY 2014. For example, in FY 2013, the Department provided 64 percent of audit requests on time, compared to 73 percent in FY 2014. However, we continued to experience delays with key audit requests in FY 2014. For example:

- The response to the request for information related to the unliquidated obligations sample was provided 34 business days after the due date.
- Information on the Consular Affairs Passport Application Details was provided 28 business days after the due date.
- The overseas accounts payable accrual information was provided 21 business days after the due date.
- Year-end lease listings and "Raw Data Leases Files" were provided 20 business days after the due date.

The Department's records management practices were not standardized to properly store and maintain information for management review. In addition, we noted that the Department sometimes had difficulties in obtaining information in a timely manner from overseas posts.

The inability to produce documentation supporting financial transactions can lengthen processing times for analyses and reconciliations, as well as increases the possibility of undetected errors. Delays in providing accurate financial information can lengthen financial reporting cycle times, which decreases the relevance of financial information to end users. Providing timely and accurate information to the financial statement auditors could potentially lead to cost savings in performing the audit.

This issue was initially reported in our FY 2010 management letter.

Recommendation:

We recommend that the Department enhance its procedures to ensure that information is provided to the financial statement auditor in a timely manner and standardize its records management practices.

III. Fund Balance with Treasury

Insufficient Fund Balance with Treasury Reconciliation Process

Agencies are required to promptly reconcile Fund Balance with Treasury (FBWT) information in order to identify and resolve differences between the agency financial records and the Department of the Treasury (Treasury) fund balances. The Department maintains two cash reconciliation reports: the Global Financial Services-Charleston Cash Reconciliation Report and the Financial Reporting Analysis (FRA) Cash Reconciliation Report. These reports document final balances for each Treasury Account Fund Symbol for the applicable accounting period. Because of the disaggregated nature of the Department's operations, the FBWT reconciliation process involves the reconciliation of disbursements and collections processed both domestically and overseas, as well as through third parties.

The Department records unreconciled differences identified during the FBWT reconciliation process in a suspense account until the discrepancies are resolved. A suspense account is a temporary account used by agencies to record transactions with discrepancies until a determination is made on the proper disposition of the transaction. Treasury allows entities with a justifiable business need to submit a request to use suspense accounts, which are only to be used as a temporary holding place for transactions that must be cleared within 60 days.

We obtained and reviewed the FRA Cash Reconciliation Report as of June 30, 2014, and identified 131 instances in which a variance existed between Treasury and Department fund balances. These variances amounted to a net difference of approximately $6.6 million. However, when the absolute value of all variances was considered, the variance totaled approximately $87.8 million.

We also found that the Department had historical balances in several suspense accounts that had not been researched and resolved within 60 days as required. Specifically, we identified three suspense accounts in which the balance remained unchanged during FY 2014.

The Department reconciled disbursements and collections at the transaction level monthly; however, the Department did not investigate and resolve all variances. In addition, the Department did not have a complete history of transactions that it could compare with Treasury information, as data from previous financial systems were not available to the staff performing the reconciliations. These data restrictions continued to prevent the Department from fully reconciling the FBWT account. The Department also did not have appropriate controls in place to ensure all suspense activity was researched and resolved within the required 60 days.

Failure to implement timely and effective reconciliation processes could:

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

This issue was initially reported in our FY 2009 management letter.

Recommendation:

We recommend that the Department enhance its Fund Balance with Treasury reconciliation process by:

- Completing a thorough review to identify older reconciling items and taking the appropriate actions to resolve these items.
- Implementing a control to ensure that suspense account transactions approaching 60 days old are researched and resolved.

IV. Payroll

Inadequate Control Over Personnel Records and Actions

The Department's workforce includes Civil Service, Foreign Service, and FSN staff. Civil Service and Foreign Service employees are paid according to standard Federal Government pay scales using the Consolidated American Payroll Processing System (CAPPS). FSN employees are generally paid in local currency and their salary and benefits are based on local prevailing practice, which is documented in each post's LCP. Locally Employed (LE) staff are paid using the FSN Payroll system and GFACS-LE.

Ensuring the sufficiency of controls over personnel-related activities is a key responsibility of managers. We identified control deficiencies related to maintaining personnel records, processing personnel actions and calculating benefits, and processing employee separations.

This issue was initially reported in our FY 2009 management letter.

Insufficient, Inconsistent, or Incorrect Personnel Record Documentation

The Office of Personnel Management requires agencies, including the Department, to maintain up-to-date, complete, and correct personnel records for each employee. These personnel folders should include all benefit election forms, as well as any elections resulting in deductions to an employee's pay. In addition, the Department is required to review time and attendance submissions for accuracy. Maintaining up-to-date personnel folders and reviewing time and attendance submissions for accuracy helps ensure that employees are compensated only for actual hours worked and benefits earned.

To verify the accuracy of Civil Service and Foreign Service employee salaries and benefits, we assessed the completeness of personnel records for a sample of 78 employees. Table 4 describes the discrepancies identified during our testing as well as the results of our testing from FY 2012 and FY 2013 for comparative purposes.

Table 4: Discrepancies in Personnel Records

Discrepancy	FY 2014	FY 2013	FY 2012
Employee timesheets were not provided	16	22	5
Employee timesheet provided was not properly approved	8	1	0
Request for Leave or Approved Absence Forms (Standard Form [SF]-71) were not provided.	12	9	4
Annual leave hours reported on the SF-71 were not the same as the employee's annual leave hours on their Earning and Leave Statement (ELS).	1	0	0
Sick leave hours reported on the SF-71 were not the same as the employee's sick leave hours on their ELS.	2	1	0
Overtime and other premium pay hours were not compensated at the appropriate rates.	5	0	0
Life Insurance Election Form (SF-2817) was not provided.	8	12	4
Federal Employees' Group Life Insurance (FEGLI) election selected on the SF-2817 was not the same as the election on the employee's Notification of Personnel Action (SF-50).	10	2	3
Health Benefit Election Form (SF-2809) was not provided.	3	0	2
Health benefits election selected on the SF-2809 did not match the election on the employee's ELS	9	4	0

Discrepancy	FY 2014 Exceptions	FY 2013 Exceptions	FY 2012 Exceptions
Thrift Savings Plan (TSP) election form was not provided.	6	0	7
TSP election selected on the TSP election form did not match the election on the employee's ELS	33	5	1
TSP withholding amount on the employee's ELS did not recalculate based on the employee's TSP election percentage selected on the TSP election form and documented on the ELS.	7	0	0

Each bureau and post has been delegated the authority to approve personnel actions, enter the information into the personnel system, and submit information to the payroll service centers in either Charleston or Bangkok for inclusion in payroll files. We found that bureaus and posts were processing personnel actions inconsistently. Additionally, bureaus and posts did not always submit information to the payroll service centers in a timely fashion or at all. Additionally, the Department did not sufficiently oversee and review the documentation maintained in personnel files and time and attendance reports.

Poor administrative control over the payroll cycle and lack of sufficient and updated supporting documentation in the Official Personnel File may lead to errors in employee pay, improper benefit elections, or increased benefit costs. Incomplete personnel records prevent the timely receipt of sufficient and accurate documentation when requested and hinder the prompt identification and remediation of errors, which may increase the risk of waste, fraud, and mismanagement.

Recommendation:

We recommend that the Department strengthen controls over personnel records by:

- Conducting periodic reviews of personnel records.
- Instituting mandatory training sessions.
- Increasing accountability for employees processing personnel actions at the bureaus and posts.

Improper and Untimely Processing of Personnel Actions

The Department processes personnel actions when an employee is hired or an existing employee has a change in personnel status, such as resignation, retirement, or promotion. These personnel actions are documented either on the SF-50 or the Joint Form (JF) 62A (Personal Services Contracting Action).

We selected a sample, from FY 2014, of 78 payroll disbursements, 45 separated employee personnel actions, and 45 new hire employee personnel actions from CAPPS; 80 payroll disbursements, 34 separated employee personnel actions, and 40 new hire personnel actions from FSN Payroll; and 20 payroll disbursements, 10 separated employee personnel actions, and 10 new hire personnel actions from GFACS-LE to test controls over time and attendance (T&A), personnel actions, hiring, and separations. For each of the sample items selected, we reviewed the SF-50 or JF-62A for proper and timely approvals.

Tables 5, 6, and 7 summarize the exceptions noted during our CAPPS, FSNPay, and GFACS-LE payroll testing, as well as the results of our testing from FY 2012 and FY 2013 for comparative purposes.

Table 5: Exceptions Noted in CAPPS Payroll Testing

CAPPS Testing Results	FY 2014	FY 2013	FY 2012
Personnel actions in our payroll disbursement sample were not approved in the pay period following the effective date on the personnel action.	9	4	11
Personnel actions in our separated employee sample were not approved in the pay period following the effective date on the personnel action.	10	5	15
Personnel actions in our separated employees sample were not provided.	1	0	0
Separated employees in our separated employee sample were not deactivated in the personnel system in the pay period following the SF-50 separation effective date.	2	0	16
Personnel actions in our new hire employee sample were not approved in the pay period following the effective date on the personnel action.	5	0	8
Personnel actions in our new hire employee sample were not provided.	1	0	0

Table 6: Exceptions Noted in FSNPay Payroll Testing

FSN Payroll Testing Results	FY 2014	FY 2013 s	FY 2012
Personnel actions in our payroll disbursement sample were not approved in the pay period following the effective date on the personnel action.	14	16	17
Employee separations were paid incorrectly following the SF-50 separation effective date.	2	0	0

Table 7: Exceptions Noted in GFACS-LE Payroll Testing

GFACS-LE Testing Results	FY 2014	FY 2013	FY 2012
Personnel actions in our GFACS-LE disbursement sample were not approved in the pay period following the effective date on the personnel action	1	Not Applicable*	Not Applicable*

* GFACS-LE was not implemented in FY 2012 and not tested in FY 2013.

Each bureau and post had been delegated the authority to approve personnel actions and enter the information into the personnel systems. We found that bureaus and posts were processing personnel actions inconsistently. The Department did not have a centralized process to ensure that bureaus and posts were approving employee actions and entering the information into the personnel system in a timely manner.

The potential for improper payment exists if personnel actions are not processed properly or timely. In addition, the lack of proper oversight of personnel actions may result in errors remaining undetected and uncorrected for long periods of time. Untimely personnel actions are often processed retroactively, leading to supplemental payments being processed manually and increasing the risk of human error and decreasing efficiency.

Recommendation:

We recommend that the Department develop centralized monitoring procedures that will ensure bureaus and posts are complying with policies for timely and appropriately approving personnel actions, including periodic reviews of documentation.

V. Revenue

Inadequate Controls Over Machine Readable Visa Fee Analysis

The Bureau of Consular Affairs (CA) is responsible for issuing non-immigrant visas, referred to as Machine Readable Visas (MRV), to foreign nationals at 270 embassies and consulates. CA encourages posts to collect the MRV fees offsite to limit the Department's cash collection responsibilities. Posts must maintain proper internal controls to ensure that the offsite locations properly execute their duties on behalf of the Department by collecting the appropriate fees and remitting all fees collected to the Department. To achieve this objective, CA directs each post to perform, at least weekly, an MRV fee analysis by comparing the fees collected with the number and type of services provided, as identified by records other than the fee receipts. The MRV fee analysis should ensure that the cumulative amount of fees collected by the offsite location meets or exceeds the cumulative number of MRV applications processed by the post. The collections made at off-site locations directly affect revenue reported by the Department.

During the FY 2013 financial statement audit, we tested the operating effectiveness of the weekly MRV Fee Analysis at eight posts and noted exceptions at seven of eight posts. For example, we found that one post had 17 weeks of cumulative deficits and another post had 16 weeks of cumulative deficits. Although CA had implemented improvements to the MRV fee analysis process, CA officials indicated that data integrity issues continued, which contributed to cumulative deficient balances. CA officials also stated that planned changes to the control design would not be fully implemented until FY 2015. Based on this information, we did not perform additional testing during this audit.

CA's existing controls over the MRV fee analysis process were not adequately designed to ensure that revenue recorded from offsite receipts accurately reflected services provided by post. Specifically, CA had not established an absolute (dollar-base) or relative (percent-based) threshold to direct the Accountable Consular Officer's (ACO) efforts for investigating and documenting the causes of cumulative deficits. CA also had not fully developed formal guidance to standardize the process that ACOs must complete to investigate cumulative deficits and document explanations. In addition, although CA may be monitoring deficit balances and explanations at posts, evidence of this monitoring control was not documented.

Without proper controls, cash collected at offsite locations could be misappropriated and not deposited in the Department's accounts. In addition, the Department may not be able to detect inaccuracies in recording MRV fee collections, which may increase the risk of waste, fraud, and mismanagement.

This issue was initially reported in our FY 2011 management letter.

Recommendation:

We recommend that the Department:

- Continue to identify data integrity issues causing cumulative deficit balances in order to further improve the quality of the data produced in the Machine Readable Visa Fee Reconciliation Report.
- Develop, document, and implement a process to formally assess and document the cause of cumulative deficits above an agreed-upon threshold.
- Update the design of centralized controls over the Machine Readable Visa fee reconciliation process to evidence the monitoring of cumulative deficits.

VI. Property, Plant, and Equipment

Inaccurate Accounting for Capital Leases

Capital leases are leases that transfer substantially all of the benefits and risks of ownership to the lessee. Of the 9,700 real property leases used by the Department overseas, only 27 leases were capitalized in the Department's FY 2014 financial statements. During the audit, we tested all 27 reported capital leases to determine whether the Department correctly accounted for these leases. We identified eight specific exceptions with the valuation of five assets recorded as capital leases. For example, we found that:

- The acquisition cost of three leases was not recorded correctly.
- The lease liability reported for two leases was not correct.
- The depreciation expense and accumulated depreciation for two leases were incorrect.

The Bureau of the Comptroller and Global Financial Services (CGFS), which calculates the accounting information that will be reported in the financial statements for capital leases, did not receive copies of all lease agreements, amendments, and renewals timely, and was therefore unable to ensure the accuracy of the recorded lease amounts. As a result, the Department may misstate future minimum lease payments and expenses.

This issue was initially reported in our FY 2013 management letter.

Recommendation:

We recommend that the Department refine the process for accounting for capital leases. Specifically, the Bureau of the Comptroller and Global Financial Services should implement a process to obtain the documentation needed to accurately account for capital leases.

Inaccurate Recording of Software in Development

Federal agencies use various types of software, such as applications for operating a program or administrative applications. These applications, called internal use software (IUS), can be purchased off-the-shelf from commercial vendors or can be developed internally or by external contractors. Applications in the development phase are considered software in development (SID). Agencies are required to report software as general property in the financial statements.

During our audit, we performed testing to assess whether the Department was accurately identifying, reporting, and valuing IUS and SID in its financial statements. We found 15 instances where the Department either did not accurately record IUS and SID or provide adequate supporting documentation. For example,

- Seven amounts recorded did not agree with supporting documentation.
- Three projects were not transferred in a timely manner from SID to IUS.
- Costs associated with SID were recorded incorrectly on four occasions.

For SID and IUS, Department managers did not enter accounting information into the Department's accounting system as transactions occurred. Instead, the Department's method for tracking and recording software costs that should be capitalized was based on a quarterly manual data call process. The effectiveness of the process relies on the responsiveness and understanding of individual project owners. Insufficient guidance was provided to the project owners to understand how to properly account for the costs associated with the IUS and SID projects. In addition, the Department did not have a process to ensure that the information provided by the project owners was accurate or complete. Further, the Department's process to review the status of projects that were nearing completion did not always ensure that projects were correctly transferred from SID to IUS.

As a result of the control deficiencies related to SID and IUS, the Department's financial statements were misstated.

This issue was initially reported in our FY 2013 management letter.

<u>Recommendation</u>:

We recommend that the Department improve its processes for tracking and recording software costs. Specifically, the Department should:

- Automate the process for accounting for software-related costs.
- Develop and implement a process to ensure software in development and internal use software listings are complete.
- Improve monitoring activities for projects nearing substantial completion to ensure the projects are transferred to the internal use software account in a timely manner.
- Improve training on the criteria for capitalized costs for project owners.
- Develop and implement a process to review information submitted by the project owners to ensure the information is accurate.

VII. Asbestos Liability

Inaccurate Supporting Data for the Asbestos Remediation Estimate

Asbestos is a mineral-based material that was widely used worldwide in construction during the 19th and early 20th centuries due to its affordability and resistance to fire, heat, and electrical damage. The Department owns buildings that were constructed when the use of asbestos in various building materials was common. Due to health concerns, many countries prohibited the use of asbestos in building materials in the 1980s and 1990s. The Department's Bureau of Overseas Buildings Operations (OBO) periodically assesses posts to identify buildings that contain asbestos-containing building materials (ACBM). Upon completion of this analysis, the results of each post are recorded in OBO's Facilities Environmental Tracking System (FACETS). Due to the significance of its property inventory and the lack of property-specific estimates, the Department uses a cost modeling technique to estimate asbestos-abatement costs. The data in FACETS is used as the starting point for the Department's asbestos remediation cost model.

We reviewed the data in FACETS as of December 31, 2013, by selecting a risk-based sample of 36 overseas buildings for physical confirmation. We toured each selected facility to corroborate FACETS data. We were unable to confirm the physical existence of ACBMs at several of the facilities. In addition, two buildings included in the sample were leased. The Department would not be responsible for abating asbestos at leased facilities. Table 8 provides information on the exceptions identified during site visits.

Table 8: Post Asbestos Existence Testing Exceptions

Post	Number of	Number of Buildings with	Number of Leased Properties
Bogota	3	0	0
Beijing	1	0	0
Mexico City	16	3	1
Vienna	10	4	1
London	6	2	0
Total	**36**	**9**	**2**

The Department did not have an effective process to ensure that FACETS is updated to reflect the most current conditions at overseas posts. At each overseas post included in our audit, the facility surveys were performed several years prior to our testing. The exceptions we identified related to instances where the facilities had been renovated after the assessment, which included the removal of ACBMs. FACETS was not updated to reflect these renovations. In response to our audit findings, the Department implemented a data call process for overseas post officials to alert OBO of necessary updates to FACETS. Although documentation was provided to demonstrate that several posts had responded to the data call, we found that the posts visited during our audit did not communicate the remediated ACBMs identified during our site visits.

In addition, the Department did not have an effective process to ensure that leased properties were excluded from its asbestos estimate.

Inaccurate or outdated underlying data regarding the presence of asbestos in its facilities may limit the Department's ability to produce a reasonable asbestos remediation estimate. Specifically, when posts are nonresponsive to the Department's data calls, facility records may not reflect the removal of ACBMs, which will result in an overstatement of estimated cleanup costs.

This issue was initially reported in our FY 2013 management letter.

Recommendation:

We recommend that the Department strengthen its processes for maintaining accurate data to support its asbestos remediation estimate. Specifically, the Department should continue to improve procedures to ensure that facility specific data supporting its remediation estimate is accurate and current.

NEWLY IDENTIFIED

During the audit of the Department's FY 2014 financial statements, some additional matters came to our attention that had not been reported in the FY 2013 internal control report or management letter.

I. Property, Plant, and Equipment

Incomplete Heritage Asset Disclosure

Heritage assets represent unique property with historical, cultural, or architectural significance. The Department has heritage assets that are held for public exhibition, education, and official function, including collections of artwork, furnishings, books, and real property. Federal accounting standards require agencies to compile and report information related to heritage assets, such as a description of the heritage assets or categories of assets, the physical number of assets held by the agency, and a general assessment of the condition of the assets.

The International Boundary and Water Commission, United States and Mexico, United States Section (USIBWC) is a component of the Department for financial reporting purposes. USIBWC applies the boundary and water treaties of the United States and Mexico and settles differences that may arise in their application.

We performed procedures to assess the completeness and accuracy of the heritage asset disclosure in the Department's financial statements. Based on these procedures, we noted that USIBWC has heritage assets that were not included in the Department's heritage asset disclosures. Specifically, USIBWC has 138 Monument mile markers, which demarcate the

United States and Mexican border. In addition, USIBWC has one storage dam and hydroelectric power plant that it considers a heritage asset.

The Department did not have a process to consolidate relevant USIBWC heritage asset information in the financial statements. The Department has a quarterly data call process that captures the Department's heritage asset collections, but the Department did not include controls to capture heritage asset information from USIBWC.

Without a process to consolidate relevant USIBWC heritage asset information, the Department's financial statement note disclosure is incomplete. Although the costs of the assets are not reported in the financial statements, the reported heritage asset information is necessary to demonstrate the long-term benefit of these assets to the public and show that the Government is sufficiently responsible and accountable for these assets.

Recommendation:

We recommend that the Department develop a process to ensure that all relevant information on component entity heritage asset collections is consolidated into the financial statement note disclosures.

Potential Unrecorded Capital Assets

The Department manages the acquisition and leasing processes of real properties at over 200 overseas posts. Properties are acquired or leased based on the needs of the Diplomatic mission, many of which involve unique local economic conditions and real estate practices. Generally, Department-owned real property is capitalized at cost, and leased assets are treated as either capital or operating leases. Capital leases are leases that transfer substantially all of the benefits and risks of ownership to the lessee. Operating leases allow for the use of an asset but do not convey ownership rights.

During a site visit to U.S. Embassy London, United Kingdom, we performed procedures to assess the completeness and accuracy of the post's property records. During this work, Department officials provided a locally-maintained list of recent real property transactions, including four recent real estate purchases and one in-process real estate purchase. Each purchase involved the acquisition of multiple residential units within a residential complex. One of the four purchases was designated as a Department-owned asset in the Department's accounting records and the other three properties were included in the Department's operating lease listing.

We obtained supporting documentation that indicated that each transaction was classified as a leasehold title purchase under English real estate law. Leasehold owners are granted ownership for a specific extended amount of time such as 99 years. Leasehold owners often are required to pay nominal annual ground rents to the landlord. Leasehold owners have the rights to sell leasehold properties and can often extend the duration of the leasehold term upon expiration.

The Department did not have a process to analyze the unique leasehold purchase transactions in London to determine the most appropriate accounting treatment. In addition, the Department lacked effective analytical procedures to search for unrecorded capital assets, such as inquiring of posts that are in the process of relocating an Embassy, which would be more likely to have recent property transactions.

The Department's capital assets included in its financial statements may be incomplete. As a result of our inquiries, the Department began to research the specific properties identified during the audit and similar properties in other locations. However, the Department's analysis was not complete prior to the finalization of its FY 2014 financial statements.

Recommendation:

We recommend that the Department:

- Develop and execute a process to assess unique real estate acquisitions, such as leasehold purchases, for capitalization.
- Expand and refine analytical procedures to confirm the completeness of the Department's capital asset records.

STATUS OF PRIOR YEAR MANAGEMENT LETTER FINDINGS

The current status of findings reported in the management letter related to the audit of the Department's FY 2013 financial statements is summarized in Table 9.

Table 9: Current Status of Prior Year Management Letter Findings

FY 2013 Management Letter Findings	FY 2014 Status
Inaccurate Personnel Data for Foreign Service National Employees	Repeat
Insufficient Controls over Foreign Service National After-Employment Benefits	Repeat
Untimely Responses to Audit Requests	Repeat
Insufficient Fund Balance with Treasury Reconciliation Process	Repeat
Inadequate Control Over Personnel Records and Actions	Repeat
Inadequate Controls Over Machine Readable Visa Fee Analysis	Repeat
Insufficient Process to Account for Improvements to Domestic Leased Property	Closed
Inaccurate Accounting for Capital Leases	Repeat
Inaccurate Recording of Software Costs	Repeat
Inaccurate Supporting Data for the Asbestos Remediation Estimate	Repeat