



FISCAL YEAR 2002 PERFORMANCE AND ACCOUNTABILITY REPORT

FINANCIAL SECTION

INTRODUCTION TO PRINCIPAL FINANCIAL STATEMENTS

The Principal Financial Statements (Statements) have been prepared to report the financial position and results of operations of the U.S. Department of State (Department). The Statements have been prepared from the books and records of the Department in accordance with formats prescribed by the Office of Management and Budget (OMB) in OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*. The Statements are in addition to financial reports prepared by the Department in accordance with OMB and U.S. Department of the Treasury (Treasury) directives to monitor and control the status and use of budgetary resources, which are prepared from the same books and records. The Statements should be read with the understanding that they are for a component of the U.S. Government, a sovereign entity. The Department has no authority to pay liabilities not covered by budgetary resources. Liquidation of such liabilities requires enactment of an appropriation.

For 2002, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, and the Combined Statement of Financing are significantly different than last year's Statements. Specifically, the Department is reporting under new financial statement formats prescribed by OMB Bulletin 01-09. Accordingly, comparative amounts are not presented for these statements. In addition to changing its reporting formats, the Department has adopted several new Federal accounting standards effective for 2002 and 2001.

The **Consolidated Balance Sheet** provides information on assets, liabilities, and net position similar to balance sheets reported in the private sector. Comparative data for 2001 are included, and intra-Departmental balances have been eliminated from the amounts presented.

The **Consolidated Statement of Net Cost** reports the components of the net costs of the Department's operations for the period. The net cost of operations consist of the gross cost incurred by the Department less any exchange (i.e., earned) revenue from our activities. Comparative data for 2001 are included, and intra-Departmental balances have been eliminated from the amounts presented.

The **Consolidated Statement of Changes in Net Position** reports the beginning net position, the transactions that affect net position for the period, and the ending net position. For 2002, the components of net position are separately displayed in two columns: Cumulative Results of Operations and Unexpended Appropriations to more clearly identify the components of and changes to Net Position. Intra-Departmental transactions have been eliminated from the amounts presented.

The **Combined Statement of Budgetary Resources** provides information on how budgetary resources were made available and their status at the end of the year. Information in this statement is reported on the budgetary basis of accounting. Intra-Departmental transactions have not been eliminated from the amounts presented.

The **Combined Statement of Financing** reports the relationship between budgetary transactions and financial transactions. Intra-departmental transactions have not been eliminated from the amounts presented.

Required Supplementary Stewardship Information provides information on the Department's Heritage Assets. **Required Supplementary Information** contains a Combining Schedule of Budgetary Resources that provides additional information on amounts presented in the **Combined Statement of Budgetary Resources**, and information on intra-governmental amounts, deferred maintenance, and the Department's Working Capital Fund.

The Department received an "Unqualified Opinion" on its financial statements for 2002, 2001, 2000, 1999, 1998 and 1997. The opinions were from an independent public accounting firm engaged by the Department's Office of Inspector General.

FISCAL YEAR 2002 PERFORMANCE AND ACCOUNTABILITY REPORT

INDEPENDENT
AUDITOR'S REPORT






**United States Department of State
and the Broadcasting Board of Governors**

Inspector General

February 2, 2003

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TO: The Secretary
FROM:  *Richard N. Reback*
OIG - Richard N. Reback, Acting
SUBJECT: Audit of the U.S. Department of State 2002 and 2001
Principal Financial Statements - Audit Report
AUD/FM-03-18

In compliance with the Chief Financial Officers Act, the Office of Inspector General (OIG) contracted with Leonard G. Birnbaum and Company, LLP (LGB), an independent certified public accounting firm, to audit the Department's principal financial statements as of September 30, 2002, and for the year then ended.

During its audit, LGB found:

- that the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;
- four reportable conditions related to internal controls, of which one is a material weakness regarding information system security;
- that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996; and
- instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management systems.

The internal control and noncompliance issues underscore the need for the Department to improve its financial management systems. The auditor's unqualified opinion was achieved for the

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most part through the extensive efforts of financial management staff to overcome those weaknesses and produce auditable information, and LGB's efforts to complete its audit under onerous conditions. Although these efforts ultimately resulted in an unqualified opinion, reliable information was not readily available during the year. The risk of materially misstating financial information is high under the current conditions.

LGB's report, dated February 1, 2003, is attached for your review. LGB is responsible for this report and the opinions and conclusions expressed therein. OIG is responsible for technical and administrative oversight regarding performance under the terms of the contract, including assuring the audit was performed in accordance with *Government Auditing Standards* and Office of Management and Budget Bulletin 01-02, *Audit Requirements for Federal Financial Statements*. OIG made appropriate inquiries of LGB representatives and monitored the audit by:

- evaluating the nature, timing, and extent of the work;
- evaluating the qualifications and independence of the auditors;
- monitoring progress throughout the audit;
- examining audit workpapers and evaluating key judgments;
- reviewing the audit report to ensure compliance with appropriate standards; and
- performing other procedures that OIG deemed appropriate in the circumstances.

OIG's review, as differentiated from an audit in accordance with *Government Auditing Standards*, was not intended to enable OIG to express, and OIG does not express, an opinion on the Department's financial statements or conclusions about the effectiveness of internal control and compliance with certain laws and regulations. However, OIG's review disclosed no instances where LGB did not comply, in all material respects, with *Government Auditing Standards*.

The Bureau of Resource Management (RM) agreed with the findings and conclusions, and its comments are included as Appendix A to the report. In addition to this report, OIG will send a separate management letter to RM discussing several other matters that were identified during the audit.

OIG appreciates the cooperation extended to it by the Department's managers and staff during the audit.

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INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We have audited the Department of State's (Department) Consolidated Balance Sheet and Consolidated Statement of Net Cost as of, and for the years ended, September 30, 2002 and 2001 and the Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and Combined Statement of Financing as of and for the year ended, September 30, 2002 (collectively the Principal Financial Statements); we have examined internal control over financial reporting in place as of September 30, 2002; and we have examined compliance with laws and regulations.

In our opinion, the Department's 2002 and 2001 Principal Financial Statements are presented fairly in all material respects.

We found:

- a material weakness in internal control regarding information system security, which was not included in the Department's 2002 review of management controls, required by the Federal Managers' Financial Integrity Act of 1982 (FMFIA).
- instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management system.

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

PRINCIPAL FINANCIAL STATEMENTS

In our opinion, the Department's 2002 and 2001 Consolidated Balance Sheets, and Consolidated Statements of Net Cost, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 2002 and 2001, and the net cost of operations, for the years then ended and that the Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources and Combined Statement of Financing for the year ended September 30, 2002, present the changes in net position, the use of budgetary resources, and the use of financing resources for that year, in conformity with accounting principles generally accepted in the United States of America.

In 2002, the Department implemented revised financial statement reporting requirements and Statements of Federal Financial Accounting Standards that became effective for those years. The details of these changes are presented in Note 2 to the Principal Financial Statements.

INTERNAL CONTROL

We considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the Principal Financial Statements. We limited our internal control testing to those controls necessary to achieve the objectives described in the Office of Management and Budget's (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*. We did not test all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

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

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that OMB, Department management, or the Inspector General have identified as being significant for which compliance can be objectively measured and evaluated; and
- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters of internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts, which would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted the following matter that we considered to be a material weakness as defined above.

We have identified significant weaknesses related to information system security that we believe could be exploited to have a detrimental effect on the information used to prepare the financial statements. We believe that the information system networks for domestic operations are vulnerable to unauthorized access. Consequently, systems, including the Department's financial management system, which process data using these networks, may also be vulnerable. This weakness was first reported in *Computer Security: Pervasive, Serious Weaknesses Jeopardize State Department Operations* (GAO/AIMD-98-145) based on penetration tests performed by the General Accounting Office (GAO) and was then reported in our opinion on the 1997 financial statements.

The Department was able to close the recommendations related to this GAO report in FY 2000. However, we did not believe that the closure of the GAO recommendations demonstrated that the previously cited material weakness had necessarily been corrected. Therefore, the Department performed tests of access controls in this area, which identified significant weaknesses. The Department has initiated a program to assess its information systems security on a comprehensive basis. However, this work was not sufficiently advanced before our field work ended to assure ourselves that this condition no longer existed.

In addition, we identified significant weaknesses with the Paris Financial Service Center's Accounting and Disbursing System. These included access vulnerabilities, issues with the internal control environment, concerns with physical security, and environmental issues. We first reported these weaknesses in our opinion on the 1998 financial statements. A separate report detailed these concerns and recommended action (*Computer Security Reviews of Paris Accounting & Disbursement System and Consolidated American Payroll Processing System*, 00-FM-014, issued June 2000). The Department has made significant progress in addressing these weaknesses. It is also in