MANAGEMENT CONTROLS, SYSTEMS AND COMPLIANCE WITH LAWS AND REGULATIONS

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

FMFIA Annual Assurance Statement
Fiscal Year 2001

As a result of the recommendations of the Department's Management Control Steering Committee and the assurances from senior Department officials, I am pleased to certify with reasonable assurance that, except for the three pending material weaknesses identified in this report, the Department's systems of management control, taken as a whole, comply with Section 2 of the Federal Managers' Financial Integrity Act of 1982.

In addition, the Department is in substantial compliance with applicable Federal accounting standards and the U.S. Government Standard General Ledger at the transaction level. However, the Department does not substantially comply with the Federal financial management systems requirements. Therefore, the Department is unable to certify that our financial systems fully comply with Section 4 of the Federal Managers' Financial Integrity Act of 1982 at this time. We have developed a remediation plan to resolve this issue and expect to achieve substantial compliance by Fiscal Year 2003.

Secretary of State

Management Control Program

The Federal Managers' Financial Integrity Act (FMFIA) requires that agencies conduct annual reviews of the adequacy of management controls for Federal programs and activities. Based on these reviews, agencies provide a statement of assurance regarding the effectiveness of management, administrative and accounting controls, and financial management systems. The Secretary of State's 2001 Annual Assurance Statement is provided above.

The Management Control Steering Committee (Committee) oversees the Department's management control program. The Committee is chaired by the Chief Financial Officer, and is composed of nine other Assistant Secretaries including the Chief Information Officer and the Inspector General (non-voting), the Deputy Chief Financial Officer, and the Deputy Legal Adviser. Individual assurance statements from overseas Ambassadors and Assistant Secretaries in Washington, D.C. serve as the primary basis for the Department's assurance that management controls are adequate. The assurance statements are based on information gathered from various sources including the managers' personal knowledge of day-to-day operations and existing controls, management program reviews, and other management-initiated evaluations. Additional informational sources include reviews, audits, inspections, and investigations conducted by the Office of the Inspector General and/or the General Accounting Office.

Each year, Department organizations with material weaknesses are required to submit plans for correcting those weaknesses to the Committee for review and approval. These plans, combined with the individual assurance statements, provide the framework for monitoring and improving the Department's management controls on an on-going basis.

Status of Management Controls and Report on Material Weaknesses and Nonconformance

The Department evaluated its management controls and financial management systems for the fiscal year ending September 30, 2001. This evaluation provided reasonable assurance that the objectives of the FMFIA were achieved in 2001. No new material weaknesses were identified and no previously reported material weaknesses were proposed for closure.

To be considered a material weakness in management control systems for FMFIA reporting purposes, the problem should be significant enough that it meets one or more of the FMFIA Material Weakness Criteria. The chart to the right describes the criteria that the Department uses for the FMFIA review.

FMFIA Material Weakness Criteria

- Significantly impairs the Department's mission.
- Deprives the public of needed services.
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, or other assets.
- Results in a conflict of interest.
- Merits the attention of the Secretary, the President, or a relevant Congressional oversight committee.
- Is of a nature that omission from the report could reflect adversely on the Department's management integrity.

During the last five years, the Department has made significant progress by reducing the number of material weaknesses from 14 to three, including the closure of 14 and the addition of three. The Department does not have any items on the General Accounting Office's High Risk List, and has not had any since 1995. The following tables show the Department's progress during the past five years with correcting and closing material weaknesses as well as the Department's corrective actions to address the remaining three material weaknesses.

Number of Material Weaknesses by Fiscal Year

Fiscal Year	Number at Beginning of Fiscal Year	Number Corrected	Number Added	Number Remaining at End of Fiscal Year
1997	14	3	1	12
1998	12	2	-	10
1999	10	7	-	3
2000	3	2	2*	3
2001	3	-	-	3

* Reported by the Department of State as a result of the merger with USIA.

Summary of Remaining FMFIA Material Weaknesses and Nonconformance
(with Targeted Correction Date)

Material Weakness	Corrective Actions	Target Correction Date	Diplomatic Activity
Inadequate Administrative Staffing Overseas The Department suffers from an acute shortage of skilled Foreign Service administrative staff overseas. This shortage is especially critical due to the increased staffing levels of other foreign affairs agencies, which rely on the Department for administrative support without a proportionate increase in Departmental administrative support levels. The shortage of administrative personnel is believed to be a root cause of other weaknesses in administrative areas.	An Overseas Staffing Model (OSM) has been developed to identify the criteria for determining administrative staffing levels by post. The OSM sets forth a base level of administrative staffing, and provides additional positions to meet special needs. To ensure that adequate resources are available, a direct link is established between the administrative requirements and each agency's proportional cost for the support. Results from the updated OSM will be used to guide resource allocations for FY 2002 and out-year budget submissions. Administrative requirements are being met in part by instituting programs that allow Foreign Service specialists, Civil Service employees, and eligible American family members to compete for specific administrative positions overseas.	2002	Diplomatic Readiness – Human Resources
Integration of Grants Tracking Systems Multiple systems that track grant awards in support of international educational and cultural exchange programs are not fully integrated or linked to the Central Financial Management System. Integration would eliminate redundant record keeping, simplify coordination, and provide accurate and consistent data on grant costs and recipients.	Integrated systems have been developed to track grant-funded exchange projects and their participants from beginning to end. These systems are being expanded to cover all 50+ programs. The database now includes solicitation, proposal, and grants modules that are in production in the Executive Office and one program office, and will be installed in the remaining offices in 2002.	2002	Mutual Understanding
Exchange Visitor Information System (EVIS) Data discrepancies were found in EVIS. EVIS contains information on the organizations designated by the Department that conduct educational and cultural exchange programs and on the Foreign Nationals who have participated as exchange visitors in these programs.	A pilot program has been developed and tested. The information collected is being used to develop a national system in cooperation with the Immigration and Naturalization Service and the Department of Education. The system will enable the Department to acquire complete data on the participants in the exchange visitor program practically instantaneously.	2005	Mutual Understanding
Material Nonconformance	**Corrective Actions**	**Target Correction Date**	**Diplomatic Activity**
Financial and Accounting Systems The Department has identified substantial weaknesses in its financial management systems. When first reported, the Department was burdened with managing six financial management systems worldwide, which support its domestic bureaus, overseas posts, and other overseas agencies. The financial management systems' nonconformance includes the following five weaknesses: deficiencies in data quality, noncompliance with JFMIP core requirements, ineffective interfaces, inadequate documentation and audit trails, and inadequate support of mission performance.	Significant progress has been made over the past few years to improve financial management systems worldwide. The Department has reduced the number of financial systems from six to three; has reduced the number of post-level financial systems from nine to two; has decreased regional level systems from three to two; has defined a standard account code structure that is applicable across all financial and feeder systems; and has re-centralized disbursing offices from 21 to three. Attaining substantial compliance with Federal financial management systems requirements is the focus of the Department's Remediation Plan, which was established with OMB. For more detail on financial systems improvements and compliance with the Federal Financial Management Improvement Act of 1996, see the following section.	2003	Diplomatic Readiness – Infrastructure and Operations

FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT

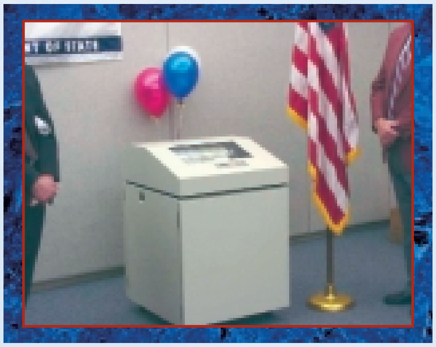
The Federal Financial Management Improvement Act of 1996 (FFMIA) is designed to improve Federal financial management by requiring that financial management systems provide reliable, consistent disclosure of financial data in accordance with generally accepted accounting principles and standards. Under FFMIA, agencies' financial management systems must comply substantially with three requirements: (1) Federal financial management system requirements; (2) applicable Federal accounting standards; and (3) the U.S. Government Standard General Ledger (SGL). FFMIA also requires that the Independent Auditor's Report on the agency's annual financial statements report whether the agency's financial management systems comply with the three requirements.

In 2001, the Department continued to maintain substantial compliance with the SGL and Federal accounting standards. However, as indicated in the Independent Auditor's Report and as agreed by State management, State is not in substantial compliance with the following Federal financial management systems requirements: timely and useful information, including managerial cost accounting information; systems security; and business continuity/contingency planning. Finally, the SGL is not the source of information for certain elements of the financial statements.

If an agency's financial systems do not comply with FFMIA requirements, the agency (in consultation with OMB) must establish a remediation plan. The Department established its initial Remediation Plan (Plan) with OMB in March 2000 in response to the Independent Auditor's Report on the 1999 financial statements. The Department submitted an updated Plan to OMB in November 2001 in response to the Independent Auditor's Report on the 2000 financial statements. The 2001 Plan, consistent with the March 2000 submission, identifies 12 initiatives to be accomplished by the end of 2003 that will result in substantial compliance. The 2001 Plan can be found at www.state.gov/m/rm/rls/ffmia/.

During 2001, the Department continued to make significant progress towards implementing the Plan. The Independent Auditor's Report shows that the Department has reduced its overall degree of noncompliance. The Department has completed five of the 12 initiatives; and completing the remaining seven initiatives in the Plan is a top priority. The CFMS Enhancements initiative consists of three parts and the third part won't be completed until April 2002.

The cornerstone of the Plan is implementation of the Regional Financial Management System (RFMS). Development and implementation of RFMS, approved by State's Information Technology Program Board in June 1998, will support State's goal of integrating and standardizing worldwide financial and information systems, and conforms with OMB Circular A-127 requirements to establish a single, integrated financial management system. RFMS will (1) reduce the number of overseas financial systems from two to one; (2) incorporate State's standard account code structure; and (3) enable financial transactions to be standardized between RFMS and State's Central Financial Management System (CFMS), which will result in consistent processing and recording of financial data worldwide.



The first checks are printed from the new RFMS disbursing system.

RFMS is on-schedule for implementation worldwide by the end of FY 2003. RFMS is comprised of a custom-developed Disbursing System and American Management Systems' off-the-shelf accounting system. The first major milestone

Richard Ivy, United States Disbursing Officer, presents checks for approval to Keith Kohler, FSN Payroll Unit Chief.

was achieved in June 2001 with the implementation of the Disbursing System component for U.S. Dollar checks at the Charleston Financial Service Center (CFSC). CFSC began printing foreign currency checks with this system in August. The second major milestone was achieved on October 31, 2001; when the first pilot post (Embassy Lima) began offering the full range of financial services under RFMS.

The following two tables provide a summary of the Plan, including the five initiatives that have been completed and the status of the remaining initiatives.

Completed Initiatives to Achieve FFMIA Compliance

Initiatives	Diplomatic Activity	Status	Description
Mainframe Access Controls Security	Diplomatic Readiness – Infrastructure and Operations-IRM/Diplomatic Security	Complete	Mainframe security for access controls was enhanced, enabling the MCSC, with the concurrence of the IG, to vote for closure of the FMFIA material weakness for Information Systems Security. The processes, controls and administration of State's information systems security program have been significantly improved since this problem was identified in 1997.
CFMS Security Improvements	Diplomatic Readiness – Infrastructure and Operations-IRM/ Diplomatic Security	Complete	New policies, procedures and security profiles were established. CFMS security awareness training was developed and provided to over 900 users of CFMS.
CFMS Mainframe Contingency Plan	Diplomatic Readiness – Infrastructure and Operations–IRM/Diplomatic Security	Complete	Two fully operational mainframe computer facilities have been established: the center in the Harry S. Truman Building in Washington, D.C., and the Beltsville Information Management Center in Beltsville, MD. If a disaster strikes one of these two facilities, critical mainframe operations could be moved to the other site, in a diminished but workable capacity.
Paris FSC Mainframe Contingency Plan	Diplomatic Readiness – Infrastructure and Operations–IRM/Diplomatic Security	Complete	A contingency plan was developed to provide appropriate contingency relief and disaster recovery for the FSC Paris mainframe using the domestic mainframe computers.
Unliquidated Obligation System and Procedures	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	Complete	The Unliquidated Obligation System facilitates the reconciliation, monitoring, reporting and oversight of unliquidated obligations worldwide. Data in the system is analyzed in various strata, and reports are produced to review and manage open items.
CFMS Enhancements: Project Cost Accounting System (PCAS)	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	Complete	The Project Cost Accounting System captures costs associated with capital improvements and construction projects, and reports these costs in State's SGL.
Fixed Assets: Phase I – Real Property	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	Complete	State implemented the Fixed Assets System, an integrated module within CFMS, to account for the real property elements of land, buildings and structures. Data from this new module automatically updates the SGL account for Property, Plant and Equipment. The CFMS general ledger is now the primary source of information on these elements for financial reporting.

Remaining Initiatives to Achieve FFMIA Compliance

Initiatives	Diplomatic Activity	Completion Date	Description	Status 9/30/2001
CFMS Enhancements Fixed Assets: Phase II – Personal Property	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	April 2002	Building on the success of Phase I, Phase II will focus on accounting for personal property using the Fixed Assets System. Upon completion, personal property amounts will be reported directly through the CFMS general ledger.	**On schedule.** Requirements analysis and data conversion software design completed. Development underway.
Enhanced Interfaces	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	September 2002	Enhance the interface between the overseas financial systems and CFMS to increase the frequency and level of detail, which will provide enough detail to meet internal and external reporting requirements.	**On schedule.** Re-engineered interface will go live November 2001.
Financial Reporting Software	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	November 2002	The software will: (1) fulfill the FACTS II reporting requirements mandated by Treasury; (2) streamline the compilation, consolidation and reporting for financial statements; (3) facilitate the production of annual and interim financial statements; and (4) enhance the Department's financial analysis capabilities.	**On schedule.** Planning, installation, design and development completed.
Central Financial Planning System (CFPS)	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	April 2003	CFPS will enable timely and accurate reporting on spending and costs, and associate that information with budget, strategic goals and program output. Implementation of CFPS will include the Managerial Cost Accounting Standards.	**On schedule.** Functional and technical requirements complete; business model development underway.
Regional Financial Management System (RFMS)	Diplomatic Readiness – Infrastructure and Operations-Central Management Systems	September 2003	RFMS supports State's goal to establish and maintain a single, integrated financial management system. RFMS will (1) replace and reduce the number of overseas regional systems from two to one; (2) incorporate State's standard account code structure; and (3) standardize financial transactions between RFMS and CFMS, which will result in consistent processing and recording of financial data worldwide.	**On schedule.** Completed disbursing module and RFMS software development; finished updates to RFMS software documentation and procedures, and production simulation. Parallel testing underway.
Business Continuity Plans	Diplomatic Readiness – Infrastructure and Operations – IRM/Diplomatic Security	September 2003	State must always be prepared to deal with a broad range of crises, ranging from natural disasters to political instability to terrorist attacks. Financial processes and financial management systems must be safeguarded should any of our business centers be faced with a crisis.	**On schedule.** RFMS Contingency and Continuity Plan under development.
Information Systems Network Security	Diplomatic Readiness – Infrastructure and Operations – IRM/Diplomatic Security	September 2003	State is implementing a comprehensive framework and process for lifecycle management of IT security. The framework and process will provide continual evaluation and improvement.	**On schedule.** Developed a Systems Security Program Plan; adopted the National Information Assurance Certification and Accreditation Program (NIACAP); established a Configuration Control Board; and implemented an ongoing penetration testing program.

GOVERNMENT MANAGEMENT REFORM ACT - AUDITED FINANCIAL STATEMENTS

The Government Management Reform Act (GMRA) of 1994 amended the requirements of the Chief Financial Officers (CFO) Act of 1990 by requiring an annual preparation and audit of agency-wide financial statements from the 24 major executive departments and agencies. The statements are to be audited by the Inspector General (IG), or an independent auditor at the direction of the IG. An audit report on the principal financial statements, internal controls, and compliance with laws and regulations is prepared after the audit is completed.

The Department's 2001 financial statements received an unqualified opinion. This year marks the fifth consecutive year that the Department's financial statements have achieved such an opinion. However, in relation to internal control, the Independent Auditor's Report cites as a material weakness the Department's information systems security for networks in domestic operations. In addition, the Report found three reportable conditions: (1) inadequacy of the Department's financial management systems; (2) management of unliquidated obligations; and (3) implementation of Managerial Cost Accounting Standards. The Independent Auditor's Report also states that the Department's financial management systems are non-compliant with laws and regulations, including the FFMIA.

The definition of material weaknesses previously discussed in the FMFIA section differs from the definition that the independent auditors use to assess and report on internal controls in their audits. Under standards issued by the American Institute of Certified Public Accountants, material weaknesses in internal control are defined as reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors or irregularities in amounts that 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.

Reportable conditions are significant deficiencies, though not material, in the design or operation of internal controls that 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.

The following table summarizes the weaknesses in internal control and compliance with laws and regulations cited in the 2001 Independent Auditor's Report, as well as the actions taken to resolve the problems.

Summary of Internal Control Weaknesses and Noncompliance with Laws and Regulations
(Refer to Independent Auditor's Report Section)

Material Weakness	Corrective Actions	Target Correction Date	Diplomatic Activity
Information System Security Information system networks for domestic operations are vulnerable to unauthorized access. Consequently, other systems including the Department's financial management systems, which process data using these networks, may also be vulnerable. This weakness was first reported based on penetration tests performed by the General Accounting Office (GAO) and was also cited in the audit opinion of the 1997 financial statements.	Mainframe security for access controls was enhanced, enabling the Management Control Steering Committee (MCSC) to close the FMFIA material weakness for Information Systems Security. The processes, controls and administration of State's information systems security program have been significantly enhanced since this problem was first identified in 1997. In response to two vulnerability reviews of State's network infrastructure, the Department established a Vulnerability Assessment Working Group. The Group is charged with analyzing the reviews and developing a risk mitigation plan of action with appropriate milestones. In addition to addressing the issues identified in penetration tests, State is implementing a comprehensive framework and process for lifecycle management of IT security. The framework and process will allow for continual evaluation and improvement. Some of the accomplishments to date include: ◆ Developed a Systems Security Program Plan (SSPP) that documents the Department's security program in its entirety. ◆ Adopted the National Security Telecommunications and Information Systems Security Instruction (NSTISSI), and the National Information Assurance Certification and Accreditation Program (NIACAP). ◆ Developed a Certification and Accreditation Document that establishes standard processes, activities, general tasks, and a management structure to certify and accredit systems. ◆ Established a 24x7 incident response team. ◆ Established an IT Configuration Control Board. ◆ Established an anti-virus program and processes. ◆ Implemented an ongoing penetration testing program.	2003	Diplomatic Readiness – Information Resources

Summary of Internal Control Weaknesses and Noncompliance with Laws and Regulations
(Refer to Independent Auditor's Report Section)

Reportable Conditions	Corrective Actions	Target Correction Date	Diplomatic Activity
Management of Unliquidated Obligations The Department's internal control process related to managing undelivered orders is inadequate. It lacks a structured process for reconciling and deobligating funds in a timely manner, which may result in the loss of those funds.	As mentioned in the Independent Auditor's Report, the Department has made significant improvements in this area. The Unliquidated Obligation System was implemented in 2000. The system is updated periodically for detailed unliquidated obligation data and facilitates the reconciliation, monitoring, reporting and oversight of unliquidated obligations worldwide. Data in the system is analyzed to facilitate the review and management of open items. For example, in 2001, instructions and reports were issued to offices to review over $2.9 billion in unliquidated obligations. We continue to develop reports and procedures to improve the management of unliquidated obligations.	2002	Diplomatic Readiness – Infrastructure and Operations
Compliance with Managerial Cost Accounting Standards (MCAS) While the Department complies with certain aspects of the Statement of Federal Financial Accounting Standards #4, it does not have an effective process to routinely collect managerial cost accounting information, establish outputs for each responsibility segment, or allocate all support costs.	The Department is making reasonable progress in implementing MCAS, but acknowledges that additional work is needed to fully comply with these standards. To address MCAS requirements and account for expenditure information needed for budgeting information and performance measurement, the Department is developing a Central Financial Planning System (CFPS). CFPS, which is included in our FFMIA Remediation Plan, will enable timely and accurate reporting of cost information, and associate that information with budget, strategic goals and program output. CFPS is scheduled to be implemented worldwide by April 2003. The functional and technical requirements phase was completed in February 2001. The next major milestone is completing a business operations model in 2002.	2003	Diplomatic Readiness – Infrastructure and Operations
Financial and Accounting Systems See discussion below.	See description below.	2003	Diplomatic Readiness – Infrastructure and Operations
Material Noncompliance with Laws and Regulations	**Corrective Actions**	**Target Correction Date**	**Diplomatic Activity**
Financial and Accounting Systems The Department has identified and acknowledged serious weaknesses in its financial management systems. When first reported, the Department was charged with overseeing six financial management systems that support its domestic bureaus, overseas posts and other overseas agencies. The financial management systems nonconformance includes the following five weaknesses: deficiencies in data quality; noncompliance with JFMIP core requirements; ineffective interfaces; inadequate documentation and audit trails; and inadequate support of mission performance.	Significant progress has been made over the past few years to improve financial management systems worldwide. The Department has reduced the number of financial systems from six to three; decreased the number of post-level financial systems from nine to two; reduced regional level systems from three to two; defined a standard account code structure applicable across all financial and feeder systems; and re-centralized disbursing offices from 21 to three. Attaining substantial compliance with Federal financial management systems requirements is the focus of the Department's Remediation Plan established with OMB. For more detail on financial systems improvements and compliance, refer to the Federal Financial Management Improvement Act Section within the Management's Discussion and Analysis.	2003	Diplomatic Readiness – Infrastructure and Operations

REPORTS CONSOLIDATION ACT OF 2000 - MANAGEMENT AND PERFORMANCE CHALLENGES IDENTIFIED BY THE INSPECTOR GENERAL

Clark Kent Ervin
Inspector General

The Reports Consolidation Act of 2000 requires that agencies include in their annual Accountability Report what the agency's Inspector General considers to be the most serious management and performance challenges facing the agency, and briefly assess the agency's progress in addressing those challenges. Some of these issues have met the FMFIA criteria for, and been reported as, material weaknesses. The others, while not meeting the FMFIA material weakness criteria, are receiving priority management attention.

In assessing the management and performance challenges facing the Department, the OIG concludes the most serious to be in the following areas:

- the protection of our people and facilities,
- the protection of information,
- financial management, including administration of programmatic monies,
- workforce planning, including the recruitment, retention and training of qualified people,
- counterterrorism and border security, and
- strategic and performance planning.

Improving Security for Our People, Facilities and Information

Recognizing the growing international threat in recent years to our staff and installations abroad, the Department has worked diligently to mitigate that threat by concentrating resources on improving security. Following the bombing of our embassies in Africa, a number of new security initiatives were enacted to counter the increased threat to the Department's overseas operations. This year OIG concluded its examination of the new programs initiated under the $1.5 billion FY 1999 Emergency Security Appropriation with a view to determining their effectiveness and whether they should continue to be funded. Some of them, like the Surveillance Detection Program, are meeting their objectives, although OIG has identified areas where they can be improved. In the case of other programs, like the Armored Car Program, OIG has recommended that the Department give serious consideration to redirecting at least some resources to other programs. One issue that needs to be considered with regard to these security programs is how they will be funded in the outyears when, in most cases, missions will be expected to pick up more and more of their costs.

The Department has recognized that the overwhelming majority of our diplomatic installations are inadequate and, in a disturbing number of cases, clearly unsafe. Responsive to Congressional criticism that it lacked a coherent strategy for new construction, the Department has developed a realistic, if ambitious, plan with a clearly defined set of priorities for future construction. OIG commends the Department for its new approach to construction planning. OIG notes, however, that the pace and extent of proposed new construction far outstrips the Department's past efforts in this area. Nineteen new projects were planned for FY 2001; 17 new projects are envisioned for FY 2002. The Department is requesting an additional $3.35 billion for the period FY 2002-2005 for new construction. OIG intends to provide the Department with an independent review of these projects with a view to identifying any contractual, construction, and security problems.

Despite the Department's aggressive construction plan, many embassies cannot expect immediate action to improve their security situation. In FY 2001, OIG conducted 47 reviews of diplomatic installations to identify physical security problems and to propose ways to resolve or, at least, mitigate them. OIG will continue this program of inspections. In addition, it will expand its review to focus on whether missions are utilizing effectively the resources and law enforcement programs provided by the Department to deepen their relationship with host government entities that provide protection and security support to embassies. The reality is that many embassies cannot expect new and safer buildings and must concentrate on using other such resources available to them to improve their security situation.

In the aftermath of September 11, it is clear that not only are U.S. Government installations overseas at increased threat, but the Department and its domestic facilities also face new challenges in protecting themselves. A comprehensive review of domestic facility security has yet to be undertaken by the Department. As a consequence, OIG began a review of the physical security and emergency preparedness posture of Main State. This review will be completed in the spring of 2002.

Protecting Classified Information

In recent years significant lapses in the protection of classified information have occurred in the Department. New procedures and processes designed to deal with information security have been introduced and appear to be addressing some of the Department's vulnerabilities in this area. The OIG has examined the new safeguards instituted by the Department, including new escort procedures, and believes that the Department is taking seriously its responsibility in this area. More needs to be done, however, and the OIG will continue to monitor Department progress in this area closely.

In the last year the Department has moved swiftly to improve its information technology domestically and abroad. The C-LAN modernization program will provide secure communications to Department overseas locations. The OpenNet Plus program is intended to provide all Department employees with desktop access to Internet. Finally, the Foreign Affairs Systems Integration project will provide a common overseas information management system to facilitate unclassified information sharing among foreign affairs agencies. Implementing these three programs will require significant funding over the next four years and represent major management and logistical challenges. OIG is reviewing these programs with a view to assisting the Department in dealing with the management hurdles they entail.

These technological improvements, which are critical to Department operations, and the expansion of the Department's reliance on Internet are changing the way the Department relates not only to its missions overseas but to domestic and foreign publics as well. These new vehicles for conducting the Department's business are not without their dangers. Without proper safeguards, they represent a vulnerability that can be used by those wishing to compromise Department operations or by those hostile elements seeking to obtain sensitive information. On an almost daily basis, the Department must repel attacks from those who would disrupt its information systems. While much has been done to protect the Department's domestic networks, missions abroad are less secure in defending themselves from external efforts to obtain sensitive information. Operating in a foreign environment, they also face internal procedural vulnerabilities with respect to sensitive information. Both OIG and Diplomatic

Security (DS) have identified poor practices in the area of information security management in a significant number of overseas posts. Moreover, a number of Department systems lack the requisite security plans. The Department has developed a remediation plan to comply with Government Information Security Review Act legislation and to address information security weaknesses.

Improving Financial Management

Financial management challenges include complying with requirements under the Federal Financial Management Improvement Act (FFMIA) and the Department's management of programmatic and assistance monies. These latter run the gamut of cultural and educational exchange programs to humanitarian assistance to programs geared to counterterrorism and narcotics. The Department has made significant strides in complying with FFMIA. It has embarked on an ambitious plan to consolidate financial operations by moving the services provided by the Paris Financial Service Center to its operations in Charleston, South Carolina. The Department is also implementing a new Regional Financial Management System for its overseas operations. OIG finds the Department to be in substantial compliance with FFMIA as it relates to applicable federal accounting standards and the U.S. Government's Standard General Ledger. However, the Department is still not in substantial compliance with federal financial management systems requirements. A revised FFMIA remediation plan was provided to OMB in November 2001, and the Department advises OMB that it will be in substantial compliance with all FFMIA requirements by the end of FY 2003. However, although OIG has issued five consecutive clean opinions on the Department's principal financial statements, weaknesses remain related to the management of unliquidated obligations, managerial cost accounting, and information system security. While the Department is making significant progress in addressing these issues, much more remains to be done. OIG is working closely with the Department to monitor and assess its progress in resolving these issues.

Managing federal assistance programs, including cultural and educational exchanges, refugee programs and law enforcement programs, remains a major management challenge for the Department. These activities are carried out through a variety of instruments such as grants, cooperative agreements and funds transfers. In FY 2000 these programs totaled more than $2.7 billion. However, the Department does not use standardized accounting systems, policies, or procedures to manage these programs. Presently, there is no formal data reporting mechanism that would allow the Department's management to know the exact amount of funds directed to these activities at any given time.

Human Resource Challenges/Workforce Planning

Congress, General Accounting Office, and the OIG have expressed concern regarding the human resource issues faced by the Department over the last decade. Among these challenges is the need to develop a workforce plan for both the foreign service and the civil service. In recent years the Department has taken these human resource issues more seriously and is making strides in developing the necessary workforce plan to meet its personnel needs. The Department is committed to reducing the time it takes to bring on qualified Foreign Service officers and to ensure that training extends in a rational way throughout officers' careers. It has also focused more attention on developing its civil service and to providing adequate training and support to its foreign national employees (FSNs). Once again, however, the Department has only recently begun to deal decisively with these challenges and must continue to allocate sufficient resources to human resource issues if it is to have the workforce that it needs to carry out its operations. A perceived division between foreign service and civil service persists and the Department should consider ways to bridge this division. The Department has initiated a leadership program for its civil service employees. This initiative is still new and will require a real commitment in resources and attention from the Department's senior managers. FSNs who are the backbone of our embassies have not always been given the attention they require. OIG applauds the Department's determination to resolve the problems relating to FSN pensions in many countries and fully supports its continuing efforts to resolve this longstanding issue.

"Rightsizing" of our diplomatic missions continues to be a major challenge. The Overseas Presence Advisory Panel Report calls for a new, permanent interagency board, chaired by the Department, that would provide guidance to agencies seeking to initiate or expand operations overseas and to Chiefs of Mission. Currently the Secretary heads a cabinet committee to implement the report's recommendations. There is resistance on the part of some agencies to limiting voluntarily the size of their offices overseas.

Key to rightsizing is empowering Chiefs of Mission to determine what constitutes adequate staffing in keeping with American interests and objectives. The President's instructions to new Ambassadors clearly reinforces their authority to direct and coordinate USG activities in their missions. Through its inspection program, which evaluates all foreign missions and domestic bureaus every five years, OIG is focusing on the obstacles and challenges facing Ambassadors in carrying out their responsibilities.

Counterterrorism/Border Security

One of the Department's most important programs for dealing with counterterrorism and border security issues relies on gathering data on known or suspected terrorists and ensuring that this information is made available to consular officers abroad. Only if officers responsible for issuing visas have such information can they effectively carry out their responsibility to prevent those who wish us ill from obtaining valid entry visas. The Consular Lookout and Support System (CLASS) is the principal mechanism for screening out criminals and terrorists who would seek to enter the United States. Since 1997, all missions abroad where visas are issued have had electronic access to this system on a real time basis. Data regarding suspected terrorists and criminals are received by the Department's Bureau of Intelligence and Research (INR) where they are processed and screened for accuracy and entered into the CLASS database. Since the events of September 11, the number of known or suspected terrorists identified by U.S. intelligence and law enforcement agencies and reported to INR for inclusion in CLASS has quadrupled from an average of 300 per month to well over 1,200 in October 2001. However, one area of concern for the OIG is how this information is handled at embassies and whether FSN employees have unauthorized access to CLASS systems.

Screening applicants through an expanded CLASS database will certainly provide a more effective means of preventing the issuance of visas to potential terrorists. However, it is not uncommon for terrorists to use fraudulent documents in their efforts to obtain valid visas. It is left for the visa officer to determine, through a personal interview, whether a visa applicant is a threat to the United States. Closer scrutiny of all applicants fitting terrorist profiles will not guarantee that potential terrorists will be identified in the interview process. First-tour officers conduct most visa interviews. They are often the sole consular officer at post and have limited supervision. Improved training for these officers is essential.

As the issuance of visas becomes more closely managed, the number of aliens fraudulently seeking to obtain U.S. passports can be expected to increase. In its current review of the Department's domestic passport operations, OIG has found that fraud prevention measures related to the processing of over seven million passports annually should be improved.

The Department should also expand its efforts to establish international enforceable standards of control by other countries, such as the use of computerized immigration records, machine-readable passports, tamper proof visas, and the safeguarding of passport inventories. The Department's own initiatives to use new technologies to make passports and visas more resistant to tampering are to be commended. Even with such improvements, however, employee malfeasance and careless security procedures in visa and passport operations can undermine the integrity of the program.

Strategic and Performance Planning

The Department has made progress in strategic and performance planning, but more needs to be done to achieve compliance with the Government Performance and Results Act. The links between activity-based performance indicators and outcomes has not always been clear and the Department has not reported on a number of performance indicators called for in its own performance plans. In its review, GAO characterized the Department's FY 2002 Performance Plan as a significant improvement over earlier plans, although some deficiencies, like vague performance targets and a lack of clear explanations of how the Department's efforts relate to those of other agencies where intersections of responsibilities occur, remain.

The OIG routinely reviews the Department's goals and performance measures as a key component of its own audits and inspections. For example, OIG concluded that the Department had established clear goals and measures for its worldwide purchase card program and overseas wireless programs, but found that the Department had not yet developed performance measures for its information security program. While the Department has an exhaustive planning process in requiring Mission Performance Plans from its diplomatic missions, the Department makes inadequate use of these in its own planning.

OTHER MAJOR MANAGEMENT CHALLENGES FACING STATE IDENTIFIED BY THE GENERAL ACCOUNTING OFFICE

In testimony before Congress, GAO identified what it considers to be the major management challenges and program risks facing the Department. Many of the challenges that GAO identified have also been identified by OIG or through the FMFIA and FFMIA reporting processes. The remaining issues raised by GAO that have not been previously discussed are:

- Drug Control. GAO recognizes that the principal source of cocaine and heroin entering the U.S. is South America, specifically from Colombia. GAO reports that the Department has had difficulty effectively managing past assistance to Colombia and recommends that State develops implementation plans to ensure that the new assistance is well managed and used effectively.

- Overseas Restructuring. While recognizing that the Department is moving forward on this issue, GAO reemphasized the need for the Department to reassess its overseas structure in light of changing political, economic, security, and technology requirements.

INSPECTOR GENERAL'S ACT AMENDMENTS – MANAGEMENT FOLLOW-UP TO OIG RECOMMENDATIONS

The information on the Department's follow-up on audit recommendations covers 2001. It includes information on the status of recommendations more than one year old without final management decisions, and the dollar value of those reports in which funds could be put to better use or costs could be disallowed.

During 2001, the Department of State tracked 41 audit reports that were more than one year old and included a total of 196 recommendations in which final action was not taken, which would have brought closure to the reports. These audits contain over $340 thousand in disallowed costs and recommended actions, which when implemented, could result in up to $2.2 million of funds put to better use. The Department is working to bring closure to the 41 audits and recognizes that the follow-up actions and compliance to the recommendations are essential to improving the effectiveness and efficiency of program operations.

Status of Audits with Recommendations that Funds Be Put to Better Use

On October 1, 2000, there were seven audits with recommendations to put funds to better use, with a dollar value of $8.3 million, in which management had not taken final action. During the year, two additional audits were completed that included a recommendation of $1.2 million being put to better use. Four audits had final actions taken in 2001 resulting in savings of $7.3 million. Therefore, on September 30, 2001, there were two audits with recommendations to put funds to better use, which were awaiting final action with a dollar value of $2.2 million.

Management Statistical Summary
41 Audits Over One Year Old Requiring Final Action

Program Area	Number of Audit Reports	Recommendations
Counter Intelligence	5	13
Financial Management	11	66
Security Oversight	15	86
Support Programs	3	12
Property Management and Procurement	4	8
Contracts and Grants	3	11
TOTALS	**41**	**196**

Status of Audits of Disallowed Costs

On October 1, 2000, there were two audits with management decision on which final action had not been taken with a dollar value of disallowed costs totaling $1.5 million. During the year one new audit with a value of $195,000 was recommended and one audit with a value of $1.4 million was resolved. Therefore, the balance at September 30, 2001 was reduced to $340 thousand.

Funds Put to Better Use and Disallowed Costs in Audit Reports

	Number of Audit Reports Identifying Amount of Funds Put to Better Use	Amount of Funds Put to Better Use	Number of Audit Reports Identifying Disallowed Costs	Disallowed Costs
Beginning Balance	7	$8,345,718	2	$1,545,000
New Audits	2	1,210,000	1	195,000
Implemented Actions	(4)	(7,336,388)	(1)	(1,400,000)
Ending Balance	5	$2,219,330	2	$ 340,000

PRESIDENT'S MANAGEMENT IMPROVEMENT INITIATIVES

The President has established a bold strategy for improving the Federal government's management and performance, which calls on the government to focus on the most glaring problems and solve them. The President incorporated this strategy into a plan that identifies 14 areas that need improvement. The chart below provides the Department's status on the *five Government-wide initiatives* described in the President's Management Reform Agenda.

Government-wide Management Reform Initiatives Department of State Implementation Status
As of September 30, 2001

Initiative	Current Status	OMB Requested Actions
Strategic Management of Human Capital Human Capital strategies will be linked to the organization's mission and vision, core values, goals and objectives. Agencies will use strategic workforce planning and flexible tools to recruit, retrain, and reward employees, and develop a high-performing workforce.	• Created a Diplomatic Readiness Task Force to manage the additional hiring planned for FY 2002 and improve recruitment outreach. • Shortened time to enter Foreign Service by offering exam twice a year and completing clearances earlier. • Developing a Domestic Staffing Model to complement other workforce planning models.	Provide to OMB a document that addresses the workforce restructuring goal that includes stricter performance measures, a plan for meeting the Human Capital Standards Scorecard, and strategies for more targeted recruitment and streamlining.
Competitive Sourcing The Administration is committed to achieving efficient and effective competition between public and private sources.	• Developing a strategy to outsource the work of 5% of employees listed in the Fair Act Inventories. • Established a steering committee to develop and oversee the competitive sourcing strategy.	Submit to OMB a management and competition plan for FY 2002 by December 2001 and for FY 2003 no later than January 2002.
Improved Financial Performance Accountability to the American people will be improved through initiatives to achieve improved financial performance.	Compliance with Federal financial management systems requirements and Federal accounting standards: • Achieved compliance with 2 (SGL and Federal Accounting Standards) of 3 requirements. • Received OMB approval of the Remediation Plan to address non-compliance with Federal financial management systems compliance. Of the 14 projects, seven are complete (see to FFMIA section). • Remaining projects on schedule for completion in 2003. Accurate and timely financial information: • Submitted the FY 2000 financial statements by the March 1, 2001 due date. • Implemented new reporting software, reducing the time spent on preparing financial statements. • Reduced year-end closing from 5 weeks in FY 2000 to 3 weeks in FY 2001. • Issued FY 2000 Annual Accountability Report by the March 31, 2001 due date. Reduction in Erroneous Payments: • For FY 2000, overpayments amounted to less than $2 million; $1 million of which were overpayments to Foreign Service annuitants. • Establishing an Office of Grants Financial Management to oversee grants financial activity. • Developing a program to measure and report on the extent of grant overpayments in 2002.	• Submit to OMB a financial management plan by January 15, 2002. • Provide to OMB bi-monthly updates that track pilot milestones culminating with the Direct Connect Pilot in August 2002. • Coordinate IT security efforts among the CFO, CIO and IG to ensure financial management matters are adequately addressed in the context of agency IT initiatives.

Government-wide Management Reform Initiatives Department of State Implementation Status
As of September 30, 2001

Initiative	Current Status	OMB Requested Actions
Expanded Electronic Government The Federal government can secure greater services at lower cost through an expanded electronic government, and can better meet high public demand for e-government services.	• Launched the Internet Steering Committee under the leadership of Secretary Powell to increase the role of the Internet in conducting foreign policy and supporting the Department's missions abroad. • Developed and maintain an interactive website that allows contractors to conduct business with Department contracting officers. • Deployed Opennet Plus, a program to provide Internet web access to 32,000 overseas and domestic Department users over the next two years. • Created consular websites, which provide extensive information on American citizen services overseas. • Development begun on a shared database of abducted children for use by the Bureau of Consular Affairs and other entities engaged in locating and returning abducted children. • Established the Department's Web portal to provide USG information to foreign audiences.	• Increase the percentage of investments covered by a central capital planning process. • Provide a final capital investment plan by December l7, 2001, which justifies FY 2003 spending. • Begin a 9-month remediation in January 2002 in coordination with OIRA and RMO, if the final FY 2003 capital investment plan does not provide evidence of an integrated long-term investment strategy for IT and capture total IT funding.
Budget and Performance Integration The Administration plans to formally integrate performance review with budget decisions.	The full integration of performance with budget decisions in the Department will require full development of the Central Financial Planning System, targeted for implementation in FY 2003.	Develop plan with OMB and work with OMB to develop achievable goals within FY 2002.

Program Specific Initiatives: In addition to the above government-wide management initiatives, the Department is accountable for two program-specific initiatives under the President's Management Agenda. The names and status of these two initiatives are:

- **A "Right-Sized" Overseas Presence**. OMB is working with agencies to develop detailed current and historical data on their overseas positions. OMB's stated objective is "to better link USG agency assignment of personnel to overseas posts with policy, funding, and embassy construction planning." OMB and the Department are having on-going discussions about a framework for right-sizing.

- **Reform of Food Aid Programs.** In support of the President's initiative to "reform and rationalize" USG food aid programs, the Department has been working closely with USDA, USAID, OMB and the NSC to reach an interagency agreement on the overall structure and levels of USG food aid programs. Given today's serious budgetary constraints, this will require a careful balance between the Government's ability to meet humanitarian food needs while also meeting its foreign policy objectives.

FINANCIAL HIGHLIGHTS

The Department's financial statements, which appear on pages 110 through 115, received for the fifth straight year an unqualified audit opinion issued by the independent accounting firm of Leonard G. Birnbaum and Company. Preparing these statements is part of the Department's goal to improve financial management and to provide accurate and reliable information that is useful for assessing performance and allocating resources. Department management is responsible for the integrity and objectivity of the financial information presented in the financial statements.

The financial statements and financial data presented in this report have been prepared from the accounting records of the Department of State in conformity with accounting principles generally accepted in the United States of America (GAAP). GAAP for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB).

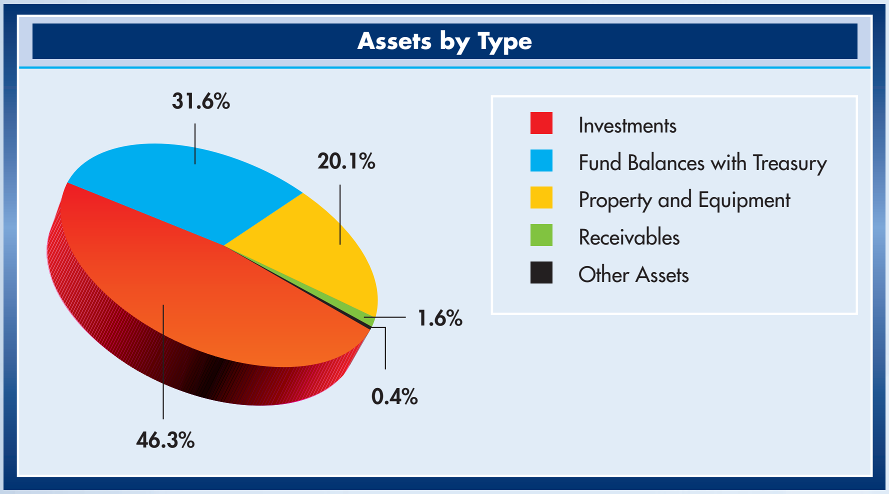
OVERVIEW OF FINANCIAL POSITION

Assets. The Consolidated Balance Sheet on pages 110 and 111 shows the Department had total assets of $24.2 billion at the end of 2001. This represents an increase of $1.2 billion (5.3%) over the previous year's total assets of $23.0 billion. The increase is primarily the result of the $537 million increase in investments in the Foreign Service Retirement and Disability Fund (FSRDF) and Fund Balances with Treasury of $550 million. The increase in Fund Balances with Treasury primarily resulted from a $0.6 billion increase in 2001 appropriations, which the Department received to continue worldwide security upgrades.

The Department's assets reflected in the Consolidated Balance Sheet are summarized in the following table *(dollars in thousands):*

	2001	2000
Investment, Net	$11,206,403	$10,669,382
Fund Balances with Treasury	7,652,119	7,101,842
Property and Equipment, Net	4,870,466	4,687,989
Accounts, Loans & Interest Receivable, Net	403,329	414,979
Other Assets	91,516	125,023
Total Assets	$24,223,833	$22,999,215

Investments, Fund Balances with Treasury and Property and Equipment comprise 98% of total assets for 2001, which is a slight increase from the 2000 percentage of 97%. Investments consist almost entirely of U.S. Government Securities held in the FSRDF.

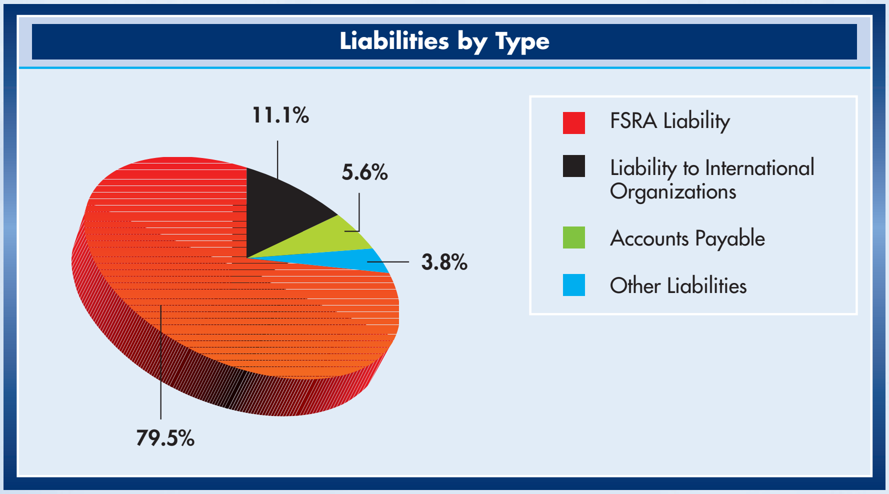


Liabilities. The Department had total liabilities of $14.8 billion at the end of 2001, which is reported on the Consolidated Balance Sheet and summarized in the following table *(dollars in thousands):*

	2001	2000
Foreign Service Retirement Actuarial Liability	$11,766,900	$11,475,900
Liability to International Organizations	1,650,006	1,608,326
Accounts Payable	823,818	611,126
Other Liabilities	569,753	624,911
Total Liabilities	$14,810,477	$14,320,263

The Foreign Service Retirement Actuarial (FSRA) Liability of $11.8 billion and the Liability to International Organizations of $1.7 billion comprise 91% of the Department's total liabilities.

Of the total liabilities, $2.4 billion (16%) were unfunded, i.e., budgetary resources were not available to cover these liabilities. The $2.4 billion is primarily comprised of the $1.7 billion Liability to International Organizations, and the unfunded portion of the FSRA Liability of $424.9 million, which represents the amount by which the $11.8 billion FSRA Liability exceeds the FSRDF's net assets available to pay the liability. The $424.9 million unfunded



portion of the FRSA Liability is $244.6 million less than the $669.5 million unfunded FRSA Liability at the end of 2000, and marks the eighth consecutive annual decrease due to the continued financial growth experienced by the FSRDF.

The $1.7 billion Liability to International Organizations consists of $755.0 million in calendar year 2001 annual assessments, and $895.1 million in accumulated arrears assessed by the UN, its affiliated agencies and other international organizations. These financial commitments mature into obligations only when funds are authorized and appropriated by Congress.

As of September 30, 2001, a total of $926 million had been appropriated by Congress for payment of U.S. arrearages. These amounts, however, were made available subject to certifications by the Secretary of State that certain legislative requirements were met. A payment of $100 million in arrearages was made in FY 2000; a payment of $475 million and a credit of $107 million were made in early FY 2002. Thus, $244 million in arrearage payments remains; we have sought additional legislation to enable payment of this third tranche of arrearage payments.

Ending Net Position. The Department's Net Position at the end of 2001 on the Consolidated Balance Sheet and the Consolidated Statement of Changes in Net Position was $9.4 billion, a $734 million (8.5%) increase from the previous fiscal year. Net Position is the sum of the Unexpended Appropriations and Cumulative Results of Operations at the end of 2001.

The growth in Unexpended Appropriations was principally due to the increase in appropriations received for security upgrades.

The increase in Cumulative Results of Operations resulted mainly from the $244.6 million net proceeds of the Foreign Service Retirement Disability Fund (FSRDF). The Cumulative Results of Operations also increased as a result of growth in the International Cooperative and Administrative Support Services (ICASS) component of the Working Capital Fund, and the acquisition of capital assets with appropriations.

RESULTS OF OPERATIONS

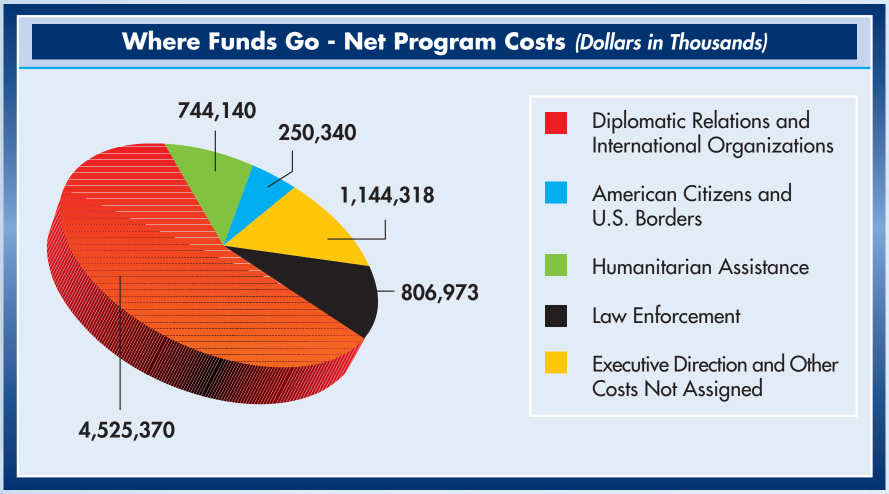
The results of operations are reported in the Consolidated Statement of Net Cost and the Consolidated Statement of Changes in Net Position on pages 112 and 113.

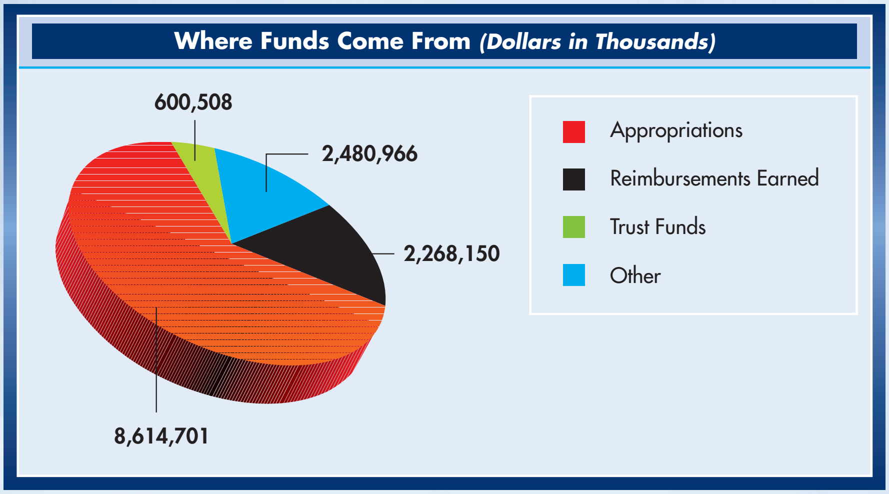
The Consolidated Statement of Net Cost on page 112 presents the annual cost of operating the Department's major programs. The total cost less any earned revenue for each program is used to determine the Net Program Cost. A Consolidating Schedule of Net Cost is presented in Note 18. The schedule displays the program costs by responsibility segment. Each Under Secretary oversees a responsibility segment and carries out their mission or major line of activity.

The programs on the Consolidated Statement of Net Cost correlate to the National Interests represented in the "Management's Discussion and Analysis" section of this report and in the Department's 2001 Performance Report. Exceptions are the National Interests of National Security, Economic Prosperity, Democracy, and Global Issues. These National Interests are carried out through, and presented collectively under, "Diplomatic Relations and International Organizations" on the Consolidated Statement of Net Cost. "Executive Direction and Other Costs Not Assigned" reflect costs and revenues related to high-level executive direction, international commissions, and certain general management and administrative support costs that cannot be reasonably allocated to programs.

The Department's Total Net Cost of Operations for 2001, after intra-departmental eliminations, was $7.5 billion. "Diplomatic Relations and International Organizations" represents the largest investment for the Department at 61% of the Department's Net Cost of Operations. The net cost of operations for the remaining programs varies from 3% to 15%.

The Consolidated Statement of Changes in Net Position presents the accounting items that caused the net position section of the balance sheet to change since the beginning of the fiscal year. Appropriations Used totaled $8.4 billion, comprising 80.1% of the Department's total revenues and financing sources after considering intra-departmental eliminations of $1.4 billion. The charts reflect the funds that the Department received during 2001 and how these funds were used.

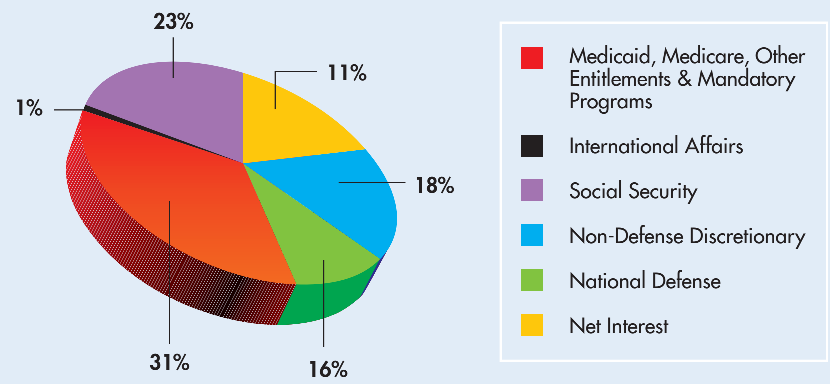




The Combined Statement of Budgetary Resources on page 114 provides information on how budgetary resources were made available to the Department for the year and their status at fiscal year-end. For the fiscal year, the Department had total budgetary resources of $14.0 billion, an increase of 4.9% from 2000 levels. Budget Authority of $9.2 billion - which consists of $8.6 billion for appropriations (direct, related and supplemental); $0.6 billion financed from trust funds; and spending authority from offsetting collections of $2.3 billion - comprise 82% of the total budgetary resources. The Department incurred obligations of $11.6 billion for the year, a slight increase over $11.2 billion of obligations incurred during 2000. The outlays reflect the actual cash disbursed against the Department's obligations.

The Combined Statement of Financing reconciles the resources available to the Department to finance operations with the net costs of operating the Department's programs. Some operating costs, such as depreciation, do not require direct financing sources.

The Federal Government Dollar



America's Best Guesses

Public Estimates on Foreign Policy Issues

Topic	U.S. Perception	Reality
Percentage of U.S. Budget going to foreign aid	20 percent	Less than 1 percent

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BUDGETARY ISSUES

The amount in the Federal budget to fund International Affairs, which encompasses several Federal agencies, is 1% of the Total Federal Government Dollar as reflected in the chart. The Department's funding related to international affairs amounts to just a fraction of 1%.

The FY 2001 Department of State's budget of $7.314 billion included the appropriations that finance the administration of foreign affairs ($4.778 billion); contributions to international organizations and activities ($1.713 billion); international commissions ($56 million); other related appropriations ($54 million); and several foreign assistance programs ($713 million). The administration of foreign affairs appropriations primarily funds the operating budgets of the Department of State and contributions to international organizations. These appropriations fund the basic platform for conducting the U.S. Government's diplomatic activities around the world as well as building and maintaining the infrastructure that supports most U.S. Government operations overseas. In addition, the Department continues to rely on Machine Readable Visa (MRV), Expedited Passport, and other user fee collections to help meet consular workload demands, and invest in modern, responsive information technology systems.

In FY 2001, the Department received appropriations that allowed it to target funding to the Department's highest priority management and policy requirements, and to invest in human resources, security, information technology, and facilities. Within these funding levels, the Department continued current operations and met the Department's highest priorities, including supporting key policy initiatives, providing adequate overseas operations, continuing worldwide security upgrades, and investing in information technology.

The Department's FY 2001 appropriations included $409 million in the operating budget and $662 million in the capital construction budget to continue worldwide security upgrades, which began after the bombings at embassies in Nairobi, Kenya and Dar Es Salaam, Tanzania. The funding provided continued programs started with the FY 1999 $1.4 billion emergency supplemental to upgrade facility security. Within this amount, the Department continued to carry out ongoing security activities, such as programs for capital construction; domestic and overseas local guards; physical security equipment; physical security technical support; armored vehicles; personnel and training; radio replacements; compound and perimeter security enhancements; and additional security positions. In FY 2002, Congress appropriated $1.3 billion to maintain security levels, upgrade perimeter security, and continue the construction of secure facilities for the Department's overseas missions.

The Department's FY 2002 appropriations represent a significant increase in the operating resources that support the Department's highest management priorities including people, technology, security, and facilities. For our major operating appropriation - Diplomatic and Consular Programs - the Department was appropriated $3.63 billion, an increase of $462 million (14.6%) from FY 2001. The increase includes $125 million for securing highly qualified people to work the front lines of diplomacy. The appropriation, along with increases in MRV fee spending, will support hiring 482 new employees (above anticipated attrition) to meet our diplomatic readiness needs, mitigate identified information security vulnerabilities overseas, and address projected border security workload increases.

Congress also appropriated $203 million for our Capital Investment Fund to provide modern information technology to every Department employee. This funding will go a long way toward providing broad-based Internet access for all of our employees and toward modernizing our classified information systems. To continue and enhance our worldwide security readiness program, Congress appropriated our full request of $488 million. This funding will allow us to hire 186 additional security personnel. In addition, Congress appropriated $1.27 billion for our important multi-year program for embassy construction, refurbishing, security and maintenance, including $665 million for construction of new secure facilities, and $141 million for compound security and other security upgrades.

Although the FY 2002 appropriations support investment and ongoing operations, the terrorist attacks of September 11 generated emergency funding requirements for Department operations. In response, the President transferred $254 million to the Department to meet our response and security needs including funding for medical response, terrorism rewards, evacuations, emergency communications, hiring 203 additional security agents, and strengthening our domestic and overseas facilities against terrorist threats.

The Department's FY 2003 budget request continues to support the Department's priorities to support the War on Terrorism and build diplomatic readiness. The request includes $1.3 billion for enhanced security and the War on Terrorism, including $755 million to design and/or construct secure facilities, additional site acquisition, and compound security projects; $553 million to upgrade worldwide security readiness including increased guard protection, chem/bio defense, and facility protection measures; and $52 million to consolidate the Department's anti-terrorism training programs for both Diplomatic Security and coalition law enforcement personnel, by establishing a new Center for Anti-Terrorism Security Training (CAST).

The request also includes funding to support hiring 631 additional Americans consisting of 134 security professionals and support staff; 399 new hires to meet the highest priority diplomatic readiness staffing needs; and 98 new consular positions to enhance Border Security and ensure the security of U.S. visas and passports. The request continues to support the Department's information technology program with a request for $177 million for the Capital Investment Fund, which would continue the investment in state-of-the-art IT systems worldwide, including extending classified connectivity to every post requiring it and expanding desktop Internet access to all Department employees.

LIMITATION OF FINANCIAL STATEMENTS

Management prepares the accompanying financial statements to report the financial position and results of operations for the Department of State pursuant to the requirements of Chapter 31 of the United States Code section 3515(b).

While these statements have been prepared from the books and records of the Department in accordance with the formats prescribed in OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, these statements are in addition to the financial reports used to monitor and control the budgetary resources that are prepared from the same books and records.

These statements should be read with the understanding that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that unfunded liabilities reported in the statements cannot be liquidated without the enactment of an appropriation and ongoing operations are subject to the enactment of appropriations.

The Department also issues financial statements for its Foreign Service Retirement and Disability Fund (FSRDF), International Cooperative Administrative Support Services (ICASS) and the International Boundary and Water Commission (IBWC). The complete, separately-issued FSRDF, ICASS and IBWC Annual Financial Reports are available from the Department's Bureau of Resource Management, Office of Financial Policy, Reporting and Analysis, 2401 E Street, Room H1500, Washington, DC, 20037; (202) 261-8620.

MILESTONES OF AMERICAN DIPLOMACY

1778: Treaty of Alliance with France, engineered by Benjamin Franklin, enabled the fledgling republic to continue its struggle for independence.

1783: Treaty of Paris-Great Britain recognized American independence and control over western lands as far as the Mississippi.

1795: Jay's Treaty required Great Britain to remove troops from northwestern frontier; Pinckney's Treaty with Spain opened mouth of Mississippi River to U.S. navigation.

1803: Louisiana Purchase removed foreign control of Mississippi's mouth and doubled U.S. territory.

1819: Adams-Onis Treaty with Spain, transferring Florida, extended the U.S. to present boundaries in southeast.

1823: Monroe Doctrine established U.S. policy of opposing European intervention or new colonization in Western Hemisphere.

1842: Webster-Ashburton Treaty with Great Britain delimited northeastern U.S. (Maine) boundary.

1846: Oregon Treaty with Great Britain extended U.S. sole dominion to the Pacific.

1848: Treaty of Guadalupe-Hidalgo, ending 1846-48 war with Mexico, confirmed U.S. claim to Texas and completed U.S. expansion to Pacific.

1867: Alaska purchase ended Russian territorial presence and completed U.S. expansion on North American mainland.

1898: Treaty of Paris, at end of Spanish-American War, transferred to the United States Puerto Rico, Guam, and the Phillipines, expanding U.S. power into the Pacific.

1918: Allies and Germany accepted Wilson's 14 points as basis for just and lasting peace ending World War I.

1945: U. S. and 50 other countries founded the United Nations.

1947: Truman Doctrine asserted U.S. policy of containing Soviet expansion through economic and military aid to threatened countries.

1947: Inter-American Treaty of Reciprocal Assistance (Rio treaty) committed the U.S. and Latin American republics to aid one another to resist military aggression.

1947: Marshall plan of aid to Europe set foundation for economic cooperation among industrial democracies.

1948: Ninth International Conference of American States created the Organization of American States (OAS) to intensify U.S. and Latin American collaboration in all fields.

1948: NATO, first U.S. alliance concluded in peacetime, provided integrated force for defense of Western Europe and North America.

1963: Limited Nuclear Test Ban Treaty, first major-power agreement regulating atomic weapons testing, banned explosions in the atmosphere, in outer space and under water.

1967: Non-Proliferation Treaty, now signed by 110 governments, banned the spread of atomic weapons.

1972: Strategic Arms Limitation Talks (SALT) agreements with U.S.S.R. prescribed mutual limitations on defensive and offensive weapons and established SALT as a continuing process.

1972: President Nixon's February visit to China followed Secretary Kissinger's earlier negotiations in Peking, marking first important step in the process of normalizing relations with the People's Republic of China.

1979: U.S. established diplomatic relations with the People's Republic of China ending 30 years of nonrecognition.

1979: Israel-Egypt Peace Treaty ended 30 years of conflict between the two countries and provided possible framework for comprehensive peace in the Middle East.

Independent Auditor's Report

United States Department of State

Washington, D. C. 20520

February 26, 2002

INFORMATION MEMORANDUM
S/S

UNCLASSIFIED

TO: The Secretary

FROM: OIG - Clark Kent Ervin CKE

SUBJECT: Audit of the U.S. Department of State 2001 and 2000 Principal Financial Statements - Audit Report AUD/FM-02-10

A copy of the audit of the Department of State 2001 and 2000 Principal Financial Statements, prepared by Leonard G. Birnbaum and Company, is attached. The audit objective was to obtain reasonable assurance and express an opinion on whether the financial statements fairly present the Department's financial position and results of financial operations in accordance with generally accepted accounting principles.

The opinion on the Department's 2001 and 2000 Principal Financial Statements is unqualified. However, the report brings to management's attention concerns about security over the unclassified network and the Paris Accounting and Disbursing System; the inadequacy of internal control over the management of undelivered orders; the implementation of managerial cost accounting standards; and the inadequacy of the Department's financial and accounting system, including its noncompliance with several laws and regulations.

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.

UNCLASSIFIED

Attachments:

Tab 1 -- Audit Report AUD/FM-02-10

cc: RM - Mr. Christopher B. Burnham

UNCLASSIFIED

LEONARD G. BIRNBAUM AND COMPANY, LLP
CERTIFIED PUBLIC ACCOUNTANTS
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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, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and Combined Statement of Financing (Principal Financial Statements) as of and for the years ended September 30, 2001 and 2000; we have examined internal control over financial reporting in place as of September 30, 2001; and we have examined compliance with laws and regulations.

In our opinion, the Department's 2001 and 2000 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 2001 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 detailed below. This report also discusses the scope of our work.

PRINCIPAL FINANCIAL STATEMENTS

In our opinion, the Department's 2001 and 2000 Principal Financial Statements, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 2001 and 2000, and the net cost of operations, the changes in net position, the use of budgetary resources, and the use of financing resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In 2000, the Department changed its method for computing fiscal year-end balances for accrued annual leave and accounts payable. In 2001, 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 1 to the Principal Financial Statements.

As discussed in Note 2 to the Principal Financial Statements, certain functions of the United States Information Agency were transferred to the Department effective October 1, 1999, resulting in a change in the reporting entity.

This report incorporates the results of our separate audit of the financial statements of the Foreign Service Retirement and Disability Fund, which, as of September 30, 2001, comprised 46 percent of the Department's assets and 79 percent of its liabilities.

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 the 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, other systems, including the Department's financial management systems, 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 the process of consolidating the Paris Financial Service Center's financial system into the Charleston Financial Service Center's system.

We are required to review the Department's current FMFIA report and disclose differences with the material weaknesses in our report. The Department's 2000 FMFIA report indicated that a previously reported material weakness in information security had been closed. That material weakness focused primarily on organization structure and procedures that, if implemented as intended, should provide adequate access controls. Currently, the Department is undertaking a comprehensive assessment of the security of its information systems. Until such time as the Department can demonstrate the effectiveness of its revised structure and procedures, this matter will be considered to be a material weakness as defined above.

We noted three matters, discussed in the following paragraphs, involving internal control that we consider to be reportable conditions.

- The Department's financial and accounting system, as of September 30, 2001, was inadequate. The principal areas of inadequacy were:

  - Certain elements of the financial statements, including, but not limited to, personal property, capital leases, and certain accounts payable, are developed from sources other than the general ledger. OMB Circular A-127, *Financial Management Systems*, requires that transaction processing be applied consistently throughout the Department's financial management system. The use of sources other than the general ledger to generate elements of the financial statements increases the potential for omission of significant transactions.

  - Some fund balances with Treasury, as reported on the Department ledgers, were not reconcilable with balances reported by Treasury. The absolute, as opposed to net, difference between the Department ledgers and Treasury balances as of September 30, 2001, approximated $131 million. While the Department has made progress in reducing the net difference between the Department ledger and Treasury balances, the weaknesses in the reconciliation processes currently in place remain, particularly with respect to older fund balances. The Department should reexamine its reconciliation processes and assess whether adjustments should be made to some of its fund balances in order to correct these weaknesses.

- The Department's internal control process related to the management of undelivered orders was inadequate. The Department has made significant improvements in this area over the past two years. The Department has actively worked with bureaus to validate undelivered orders and has successfully cleared up a significant number of obligations that were outstanding from past years. However, the Department needs to perform additional work to correct this weakness. Our tests indicated that over $300 million of undelivered orders should have been deobligated. Also, we noted that the Department's undelivered orders balance is extremely high at $3.3 billion, as of September 30, 2001. Although the Department has shown improvement in reducing this balance from last year (from $3.5 billion to $3.3 billion), only three years ago the balance was $1.7 billion. The Budget and Accounting Procedures Act of 1950 requires that the Department's accounting system provide effective control over funds. Failure to deobligate funds in a timely manner may result in the loss of availability of those funds.

The above two reportable conditions were cited in our audits of the Department's 1997 Principal Financial Statements and subsequent audits.

- Although the Department complied with certain aspects of Statement of Federal Financial Accounting Standards #4, *Managerial Cost Accounting Standards;* for instance, it chose reasonable responsibility segments, recognized the cost of goods and services that it receives from other entities, and used an appropriate allocation methodology, it did not implement an effective process to routinely collect managerial cost accounting information, establish outputs for each responsibility segment, or allocate all support costs. Until this is done, we do not believe the information will be useful as a management decisionmaking tool. This was first reported in our audit of the Department's 2000 Principal Financial Statements.

These deficiencies in internal control may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. Unaudited financial information reported by the Department, including budget information, also may contain misstatements resulting from these deficiencies.

We are not aware of any other known but uncorrected material findings or recommendations from prior audits that affect the current audit objectives.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information and Required Supplementary Information by obtaining an understanding of the Department's internal control, determined whether those internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02, and not to provide assurance on those internal controls. Accordingly, we do not provide an opinion on those controls.

Finally, with respect to internal control related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant controls relating to the existence and completeness assertions and determined whether those controls had been placed in operation as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We noted certain other internal control issues that we have reported to the Department's management in a separate letter dated February 20, 2002.

COMPLIANCE WITH LAWS AND REGULATIONS

The Department's management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. The objective of our audit of the Principal Financial Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

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

The results of our tests of compliance with the laws and regulations described in the preceding paragraph, exclusive of FFMIA, disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* issued by the Comptroller General of the United States and OMB Bulletin 01-02.

Overall, we found that the Department's financial management system did not comply with a number of laws and regulations, as follows:

- <u>Budget and Accounting Procedures Act of 1950.</u> This requires an accounting system to provide full disclosure of the results of financial operations; adequate financial information needed in the management of operations and the formulation and execution of the budget; and effective control over income, expenditures, funds, property, and other assets. However, we found that the financial systems: (1) did not manage undelivered orders effectively, and (2) did not issue interim financial statements that are necessary for effective management of operations.

- <u>Federal Managers' Financial Integrity Act of 1982.</u> This requires the implementation of internal accounting and administrative controls that provide reasonable assurance that: (1) obligations and costs are in compliance with applicable laws; (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures applicable to Department operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets. However, we found again that the financial systems did not manage undelivered orders effectively. Hence, these funds are not adequately protected from waste or loss.

- <u>Chief Financial Officers Act of 1990.</u> This requires the development and maintenance of an integrated accounting and financial management system that: (1) complies with applicable accounting principles, standards and requirements, and internal control standards; (2) complies with such policies and requirements as may be prescribed by the Director of OMB; (3) complies with any other requirements applicable to such systems; and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management; (ii) the development and reporting of cost information; (iii) the integration of accounting and budgeting information;

and (iv) the systematic measurement of performance. However, we found that the financial systems: (1) did not issue interim financial statements, which are necessary for effective management; and (2) did not provide complete information in that certain elements of the financial statements are developed from sources other than the general ledger.

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

The above areas of noncompliance were cited in our audits of the Department's 1997 Principal Financial Statements and subsequent audits.

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

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

The results of our tests disclosed instances, described below, where the Department's financial management systems did not substantially comply with the requirement to follow the federal financial management system requirements. OMB implementation guidance states that, to be in substantial compliance with this requirement, the Department must meet specific requirements of OMB Circular A-127, including the computer security controls required by OMB Circular A-130, *Management of Federal Information Resources*. We found instances of substantial noncompliance with these two requirements.

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

- Circular A-130, Appendix III, requires that the Department ensure an adequate level of security for all agency automated information systems. Specifically, the Department should ensure that automated information systems operate effectively and that there are appropriate safeguards in the automated information systems. Based on our concerns related to the financial management systems discussed in the report on internal control and the preceding paragraphs in the report on compliance with laws and regulations, we determined that the Department was not substantially in compliance with this standard.

The Department's Bureau of Resource Management (RM) has overall responsibility for the Department's financial management systems. The foregoing noncompliance has its roots in the lack of organization and integration of the Department's financial management systems. This issue has been highlighted in the Department's annual FMFIA report since 1983. In our audits of the Department's

Principal Financial Statements since 1997, we observed that the Department's financial management systems were not in compliance with FFMIA and recommended, in connection with our audits of the Department's 1997 and 1998 Principal Financial Statements, that a remediation plan be prepared. RM submitted its plan to remediate noncompliance with FFMIA to OMB on March 16, 2000. The plan projects achieving substantial compliance with FFMIA during FY 2003. RM has completed several phases of its plan and indicates that the remainder of the plan is on schedule.

We noted certain other instances of noncompliance that we reported to the Department's management in a separate letter dated February 20, 2002.

RESPONSIBILITIES AND METHODOLOGY

Department management has the responsibility for:

- preparing the Principal Financial Statements and required supplementary stewardship information, required supplementary information, and other accompanying information in conformity with accounting principles generally accepted in the United States of America;
- establishing and maintaining effective internal control; and
- complying with applicable laws and regulations.

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

In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Principal Financial Statements;
- obtained an understanding of the internal controls over financial reporting by obtaining an understanding of the agency's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls;
- obtained an understanding of the internal controls relevant to performance measures included in Management's Discussion and Analysis, including obtaining an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether they had been placed in operations;
- obtained an understanding of the process by which the agency identifies and evaluates weaknesses required to be reported under FMFIA and related agency implementing procedures;

- tested compliance with selected provisions of laws and regulations that may have a direct and material effect on the financial statements;
- obtained written representations from management; and
- performed other procedures as we considered necessary in the circumstances.

Our audits were conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin 01-02. We believe that our audits provide a reasonable basis for our opinion.

The Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information are not a required part of the Principal Financial Statements, but are supplementary information required by OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, and the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no comment on it.

This report is intended for the information of the Inspector General of the U.S. Department of State and the Department's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by the Department's management on this report are presented as Appendix A.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
February 20, 2002

United States Department of State

Chief Financial Officer

Washington, D.C. 20520-7427

FEB 22 2002

MEMORANDUM

TO: OIG – Mr. Clark Kent Ervin

FROM: RM – Christopher B. Burnham

SUBJECT: Draft Audit Report on the Department of State's 2001 and 2000 Principal Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the U.S. Department of State 2001 and 2000 Principal Financial Statements" (Report). For the fifth consecutive year, the independent CPA firm selected by the Office of Inspector General (OIG) will issue an unqualified ("clean") opinion on the Department's consolidated financial statements. This is the best possible audit result. Achieving an unqualified opinion by the February 27 due date is an important accomplishment for both of our offices.

In relation to internal control, the Report cites the Department's security for information systems networks as a material weakness. In addition, the Report cites three reportable conditions: (1) the inadequacy of the Department's financial management systems, (2) the management of unliquidated obligations, and (3) the implementation of Managerial Cost Accounting Standards. The Department's financial management systems are also reported as noncompliant with laws and regulations, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

The Department has improved the security of our mainframe and other information systems since the General Accounting Office's (GAO) review of the Department's computer security. The Department's Management Control Steering Committee (MCSC), with the concurrence of the Inspector General, approved the closure of the material weakness for Information Systems Security for the Fiscal Year (FY) 2000 Federal Managers' Financial Integrity Act (FMFIA) Report. This was based on the fact that the processes, controls and administration of the security program had been significantly enhanced since this problem was identified.

In 2001, in coordination with OIG and GAO, the Department conducted two penetration tests. The purpose was to determine whether the improvements prevent unauthorized access and abuse of the Department's information systems network infrastructure. The tests concluded that there were improvements. However, it also concluded that significant weaknesses still exist. In response, the Department established a Vulnerability Assessment Working Group that is charged with analyzing the results of the reviews and developing a risk mitigation plan of action with appropriate milestones.

In addition to addressing weaknesses identified in penetration tests, the Department is installing a comprehensive framework and process for lifecycle management of IT security. The framework and process will provide for continual evaluation and improvement. Some of the many accomplishments to date include:

- Developed a Systems Security Program Plan (SSPP) that documents the Department's security program in its entirety,
- Adaption of the National Security Telecommunications and Information Systems Security Instruction (NSTISSI), National Information Assurance Certification and Accreditation Program (NIACAP),
- Developed a Certification and Accreditation Document that establishes a standard process, set of activities, general tasks, and a management structure to certify and accredit systems,
- Established a 24X7 computer incident response team,
- Established an IT Configuration Control Board,
- Established the Remediation Program Office,
- Established antivirus program and processes, and
- Implemented an ongoing penetration testing program.

Our efforts to address this weakness include periodic meetings with staff from your Office of Audits, Leonard G. Birnbaum and Company, senior managers in IRM and our office. The purpose is to identify and coordinate actions needed to resolve the weakness and monitor progress. Beginning in March 2002, we will periodically provide a status of these efforts to the Office of Management and Budget (OMB) as part of our reporting on the President's Management Agenda. Also, we have included this initiative in our FFMIA Remediation Plan. We anticipate that our collaborative efforts will result in the status of this weakness being downgraded to a reportable condition for the FY 2002 Report.

The Bureau of Resource Management has taken a number of actions to address the security of the Paris Financial Service Center's (FSC) Accounting and Disbursing (A&D) System. As noted in the Report, the Department has made significant progress in addressing this weakness. We have resolved (i.e. "closed") 19 out of the 25 total recommendations. The remaining recommendations will be resolved through the implementation of our new Regional Financial Management System (RFMS) and consolidation of Paris FSC activities into our Charleston and Bangkok FSCs.

The weaknesses in the Department's financial management systems are a long-standing problem. Substantial compliance with FFMIA is a top priority of the Department, and improvement initiatives to achieve that goal are well underway. As required by FFMIA, the Department submitted our initial Remediation Plan (Plan) to OMB in March 2000, and an updated Plan in October 2001. The Department has completed five of the twelve initiatives identified in the plan. The Plan, which includes the installation of the worldwide RFMS to replace our overseas financial systems, calls for the Department to achieve substantial compliance with FFMIA by the end of FY 2003. We will continue to work closely with your staff during the implementation of RFMS.

Strengthening the management of unliquidated obligations (ULO) is an important financial management initiative. As mentioned in the Report, the Department has made significant improvements in this area. The Unliquidated Obligation System was implemented in FY 2000. We use this system to facilitate the reconciliation, monitoring, reporting and oversight of unliquidated obligations worldwide. Data in the system is analyzed in various strata and reports to facilitate the review and management of open items. In total, offices were asked to review over 114,000 items comprising approximately 70% of the worldwide ULO value. These processes will be repeated and expanded upon during FY 2002. We continue to develop reports and procedures to use in working with offices to improve the management of unliquidated obligations.

Implementation of Managerial Cost Accounting Standards (MCAS) is an important financial management initiative. The Department is making progress in implementing MCAS, but acknowledges that additional work is needed to fully comply with these standards. To address MCAS requirements and account for expenditure information necessary for budgeting information and performance measurement, the Department is developing a Central Financial Planning System (CFPS). CFPS, which is included in our FFMIA Remediation Plan, will enable the timely and accurate reporting of cost information and associate that information with budget, strategic goals and program outputs.

We thank you for the opportunity to comment on the draft report and for working with us in a collaborative manner on the FY 2001 financial statements. We believe that our offices have made considerable progress over the past several years. We would also like to extend our appreciation to your staff and to your contractor, Leonard G. Birnbaum and Company, for the professional and cooperative manner in which they conducted the audit for FY 2001 and prior years. The Department is committed to continuing its efforts to improve management of its programs and the quality of its financial reporting. If you have any questions concerning our response to the Report, please contact Christopher H. Flaggs, Managing Director, Financial Policy, Reporting and Analysis, on (202) 261-8625.