



United States Department of State

Washington, D.C. 20520

November 10, 1998

**INFORMATION MEMORANDUM
S/S**

TO: The Secretary *John C. Payne for*

FROM: OIG - Jacquelyn L. Williams-Bridgers

SUBJECT: Audit of U.S. Department of State's 1997
Consolidated Financial Statements (99-FM-003)

SUMMARY

The Government Management Reform Act (GMRA) requires that the Office of Inspector General audit agency financial statements and submit its report to the head of the agency. Our opinion on the 1997 Consolidated Financial Statements is unqualified, which means the financial statements were free of material misstatement. Our report brings to management's attention three significant internal control weaknesses and several instances of noncompliance with laws and regulations. Also, during the preparation of the 1998 financial statements, the Department should place appropriate emphasis on implementing the new reporting standards.

DISCUSSION

Consistent with GMRA requirements, our audit addressed the 1997 Consolidated Financial Statements. At the direction of my office, Leonard G. Birnbaum and Company performed the audit. A copy of the report is attached.

The audit objective was to obtain reasonable assurance and express an opinion on whether the 1997 Consolidated Financial Statements were free of material misstatement. We are issuing an unqualified opinion on the 1997 Consolidated Financial Statements. The report also brings to management's attention concerns with the security over the Department's domestic main-

Independent Auditor's Report

frame computer; the inadequacy of internal controls related to the management of unliquidated obligations; and the inadequacy of the Department's financial and accounting system, which is both an internal control weakness and an issue of noncompliance with several laws and regulations, including the Budget and Accounting Act of 1950, the Federal Managers' Financial Integrity Act, the Chief Financial Officers (CFO) Act, and the Federal Financial Management Improvement Act. We also bring to management's attention noncompliance with the GMRA that requires agencies to prepare audited financial statements and submit them to the Office of Management and Budget (OMB) by March 1 of each year.

The Bureau of Finance and Management Policy (FMP) agreed with our findings and conclusions, and its comments are included as appendix A to the report. In addition to this report, our contractor is sending a separate management letter to FMP, which mentions several minor internal control matters.

We are pleased with the improvements that the Department has made in financial management since the CFO Act was passed in 1990. However, a number of improvements still need to be made. In addition to the weaknesses that we have included in our audit report, we believe that the Department should ensure that adequate resources are devoted to financial statement preparation in anticipation of the increased reporting requirements for the 1998 financial statements. We are particularly concerned with implementation of OMB Bulletin 97-01, "Form and Content of Agency Financial Statements." This bulletin requires that six statements be prepared, as compared to the two statements required under the earlier guidance.

We appreciate the cooperation extended to us by the Department's managers and staff during the audit.

Attachments:

Tab 1 - Audit Report 99-FM-003

cc: FMP - Mr. Bert T. Edwards



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INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We have audited the Department of State's (Department) Consolidated Statement of Financial Position and Consolidated Statement of Operations and Changes in Net Position as of and for the year ended September 30, 1997, and have examined internal controls over financial reporting in place as of September 30, 1997. The Department's Consolidated Statement of Financial Position as of September 30, 1996, was audited by us and we expressed a qualified opinion on it in our report dated May 1, 1997. The Department's Consolidated Statement of Operations and Changes in Net Position for the year ended September 30, 1996, was not audited by us and, accordingly, we do not express an opinion on it.

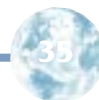
In our opinion:

- the 1997 consolidated financial statements are presented fairly, in all material respects.

We found:

- no material conflicts with the Department's report on internal controls dated December 1997, prepared under the Federal Managers' Financial Integrity Act of 1982, which cites the financial and accounting system and information systems security as material weaknesses as defined below, and
- several instances, as noted below, of noncompliance with selected provisions of applicable laws and regulations tested.

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



CONSOLIDATED FINANCIAL STATEMENTS

In our opinion, the accompanying 1997 consolidated financial statements, including the notes thereto, present fairly, in all material respects, the Department's financial position and results of operations as of September 30, 1997, on the basis of accounting described in Note 1 to the consolidated financial statements.

As described in Note 1, the Department prepares its consolidated financial statements in conformity with the hierarchy of accounting principles and standards approved by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

As discussed in Note 15 to the Financial Statements, certain errors resulting in a net overstatement of Net Position as of September 30, 1996, were discovered by the Department's management during fiscal year 1997. Accordingly, an adjustment has been made to Net Position as of October 1, 1996, to correct the errors.

As discussed in Note 16 to the Financial Statements, the Department changed its method of measuring its Pension Actuarial Liability to conform with Statement of Federal Financial Accounting Standard No. 5, *Accounting for Liabilities of the Federal Government*, which was effective for fiscal year 1997 financial reporting.

This report incorporates the results of a separate audit of the financial statements of the Foreign Service Retirement and Disability Fund (FSRDF) which, as of September 30, 1997, comprised over 55 percent of the Department's assets and 80 percent of its liabilities, and the financial statements of the International Cooperative Administrative Support Services (ICASS) program. Audits of FSRDF's statements as of, and for the years ended, September 30, 1996, and 1997, resulted in unqualified opinions. Audit of ICASS' statements as of, and for the year ended September 30, 1997, also resulted in an unqualified opinion.

INTERNAL CONTROL

We considered the Department's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance 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 Office of Management and Budget (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 on reliable and complete performance information.

For the purpose of this report, we have classified the significant internal control policies and procedures in the following categories:

- Fund Balance with Treasury
- Investments
- Accounts Receivable
- Interest Receivable
- Property, Plant and Equipment
- Accounts Payable
- Assessments from International Organizations
- Pension Actuarial Liability
- Unexpended Appropriations
- Invested Capital
- Future Funding Requirements
- Sales of Goods and Services
- Program and Operating Expenses

Our consideration of internal control would not necessarily disclose all matters of internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06, as amended, *Audit Requirements For Federal Financial Statements* (OMB Bulletin 93-06).

Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgement, could adversely affect the Department's ability to record, process, summarize and report financial data consistent with the assertions of management in the consolidated financial statements. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors or irregularities in amounts, which would be material in relation to the consolidated financial statements being audited or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the nominal course of performing their assigned functions.

We noted one matter that we consider to be a material weakness as defined above.

- The Department's main frame computers for domestic operations are considered vulnerable to unauthorized access. Consequently, other systems, including the Department's financial management systems, which process data using these computers, may also be vulnerable.

We noted two matters involving internal control that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06.

The Department's financial and accounting system, as of September 30, 1997, was inadequate. The principal areas of inadequacy were:

- certain elements of the financial statements including real property, personal property, capital improvements, capital leases, and fund balance with Treasury (in part) do not use the general ledger as a source;
- some fund balances with Treasury, principally from earlier years, as reported on the Department ledgers were not reconcilable with balances reported by Treasury; the Department's records reflect \$131 million less than the corresponding Treasury balances, a difference that is not considered material;
- certain accounts payable general ledger balances were not reconcilable with accounts payable detail;
- financial statements are not issued on a timely basis; and
- unliquidated obligation balances were significantly inaccurate, requiring an inordinate amount of manual effort to correct.

The Department's internal control process related to the management of unliquidated obligations was inadequate. This included unsupported obligations and lack of a structured process to reconcile and deobligate funds in a timely manner. For example, review of \$200 million of unliquidated obligations that had no activity during fiscal year 1997 disclosed that almost 40 percent, or \$80 million, should have been deobligated. A majority of the \$80 million was related to obligations over one year old.

We noted certain other internal control issues that we have reported to the Department's management in a separate letter dated May 29, 1998.

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 consolidated

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 93-06, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, the objective of our audit of the consolidated 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 consolidated 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 disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin 93-06, which are described below.

- The inadequacies of the Department's financial management systems are a failure to comply with:
 - the Budget and Accounting Procedures Act of 1950, which requires an accounting system that provides 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;
 - the Federal Managers' Financial Integrity Act (FMFIA) of 1982, which requires 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;

- the Chief Financial Officers Act of 1990, which 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 the Office of Management and Budget, (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;
- OMB Circular No. A-127, *Financial Management Systems*, which 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; and
- The Government Management and Reform Act of 1994, which requires the heads of designated executive agencies to prepare and submit to the Director of Office of Management and Budget an audit of financial statements by March 1, covering the preceding fiscal year.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance. Compliance with the Federal Financial Management Improvement Act of 1996 (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 United States 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 September 9, 1997.

The results of our tests disclosed instances, described below, where the agency'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 (1) meet Circular A-127 requirements, including the requirement to support management's fiduciary responsibility, (2) follow requirements published in JFMIP's Federal Financial Management System Requirements series, and (3) comply with Circular A-130, Appendix III, *Security of Federal Automated Resources*. We found instances of substantial noncompliance with these three standards.

- 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, we determined that the Department was not substantially in compliance with this standard.
- JFMIP's Federal Financial Management System Requirements state that the core financial management systems must support the partnership between program and financial managers and assure the integrity of decisionmaking information including the ability to collect accurate, timely, complete, reliable, and consistent information. JFMIP also requires that the core financial system be able to provide financial information to support internal and external reporting requirements, including as necessary the requirements for financial statements. OMB guidance states that one indicator of compliance with this standard is that the Department's core financial system, supported by other systems containing the detailed data summarized in the core financial system, be the source of information for the preparation of the annual financial statements. However, the Department's core financial system is not the sole source of information used in the preparation of the annual financial statements. Based on these issues, we determined that the Department did not substantially comply with this standard.
- Circular A-130, Appendix 3, requires that the Department assure an adequate level of security for all agency automated information systems, specifically, the Department shall assure that automated information systems operate effectively and assure 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 controls and the preceding paragraphs in the report on compliance, we determined that the Department was not substantially in compliance with this standard. The Circular also requires that the Department assure the continuity of operations of automated information systems that support critical agency functions. However, we found that the Department had not established a complete contingency/business recovery plan for CFMS.

The Department's Bureau of Finance and Management Policy has overall responsibility for the Department's financial management systems. The foregoing noncompliance has its roots in the overall lack of organization and integration of the Department's financial management systems. This issue has been reported as a high-risk area and a material weakness in the Department's annual FMFIA report since 1983. The Department should report its noncompliance with FMFIA to OMB and provide a remediation plan that includes the resources, remedies, and intermediate target dates necessary to bring the Department's financial management systems into substantial compliance. The remediation plan should be accomplished within a three year period.



We noted certain other instances of noncompliance that we have reported to the Department's management in a separate letter dated May 29, 1998.

RESPONSIBILITIES AND METHODOLOGY

Department management has the responsibility for:

- preparing the Consolidated Statement of Financial Position and Consolidated Statement of Operations and Changes in Net Position in conformity with the comprehensive basis of accounting described in Note 1 to the consolidated financial statements;
- establishing and maintaining an effective internal control structure; and
- complying with applicable laws and regulations.

Our responsibility is to express an opinion on the consolidated financial statements based on our audit. Generally accepted auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misrepresentation and presented fairly in accordance with the basis of accounting described in Note 1 to the consolidated financial statements. We considered the Department's internal controls for the purpose of expressing our opinion on the consolidated financial statements referred to above and not to provide an opinion on internal controls. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the consolidated financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the Consolidated Statement of Financial Position and Consolidated Statement of Operations and Changes in Net Position;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Consolidated Statement of Financial Position and Consolidated Statement of Operations and Changes in Net Position;
- obtained an understanding of the internal controls over financial reporting;
- tested compliance with selected provisions of laws and regulations that may materially affect the consolidated financial statements; and

- performed other procedures as we considered necessary in the circumstances.

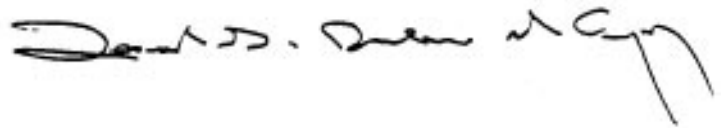
Our audits were conducted in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin 93-06. We believe that our audit provides a reasonable basis for our opinion.

The *Overview* and *Supplemental Financial Information* contain a wide range of data. Professional standards require the auditor to read this information and consider whether this information, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the consolidated financial statements. If the auditor concludes that there is a material inconsistency, the auditor should determine whether the consolidated financial statements or the other information require revision. We found no inconsistencies between data contained in the *Overview* or *Supplemental Financial Information* and corresponding data contained in the consolidated financial statements.

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



Alexandria, Virginia

May 29, 1998, except as to Notes 12 and 19, as to which the date is September 25, 1998



United States Department of State


Deputy Chief Financial Officer

Washington, D.C. 20522-1506

November 4, 1998

MEMORANDUM

TO: OIG/AUD -Mr. M. M. MacDonald

FROM: FMP/F - Larry J. Eisenhart 

SUBJECT: Draft Audit Report on the Department of State's Consolidated Statement of Financial Position for Fiscal Year 1997

This is in response to your request for comments on the draft audit report titled "Department of State's Consolidated Financial Statements for Fiscal Year 1997." In relation to internal control, the report cites the Department's computer access controls as a material weakness and two reportable conditions: (1) the inadequacy of the Department's financial management systems and (2) the inadequacy of the management of the unliquidated obligation process. In addition, the Department's financial management systems are being reported as noncompliant with laws and regulations, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

While we understand that access to the mainframe computer was obtained by a contractor for the U.S. General Accounting Office (GAO) auditors who were reviewing the Department's computer security, it is also our understanding that the contractor and the GAO auditors did not access the financial system (CFMS) software. We are reviewing CFMS security to ensure that adequate controls are in place.

The weaknesses in the Department's financial management systems are a longstanding problem, as reported in our 1997 Federal Managers' Financial Integrity Act submission. CFMS has been upgraded, and a Reports Management System has been implemented. The Department is in the process of developing and implementing a new regional-level feeder system, implementing a standard account code structure, and defining a standardized central system interface. The Department will submit a remediation plan as required by FFMIA. To strengthen management of unliquidated obligations, additional reports and procedures are being put into place.

We thank you for providing us the opportunity to comment on the draft report and for working with us in a collaborative manner on the FY 1997 financial statements. 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 audit report, please contact Christopher H. Flagg, Managing Director, Domestic Financial Services, on (703) 875-7141.