

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, 2002, was inadequate. This inadequacy prevented the Department from routinely issuing timely financial statements. The risk of materially misstating financial information is high under the current conditions. 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, 2002, approximated \$110 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.
  - During 2002, the Department used several systems for the management of grants and other types of financial assistance. These lacked standard data classifications and common processes and were not integrated with the Department's centralized financial management system. Further, the Department could not produce

reliable financial information that defined the universe of grants and other federal financial assistance.

- 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 \$230 million of undelivered orders should have been deobligated. Also, we noted that the Department's undelivered orders balance has grown significantly to \$5.8 billion, as of September 30, 2002. 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 1, 2003.

### 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:

- Budget and Accounting Procedures Act of 1950. 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 reports that could be used for effective management of operations.

- Federal Managers' Financial Integrity Act of 1982. 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, as discussed above, we found that the financial system did not manage undelivered orders effectively. Hence, these funds are not adequately protected from waste or loss.
- Chief Financial Officers Act of 1990. 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 system 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 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. Although RM has completed several phases of its plan and indicates that the remainder of the plan is on schedule, the plan needs to specifically address systems security and management of grants and other types of federal assistance.

We noted certain other instances of noncompliance that we reported to the Department's management in a separate letter dated February 1, 2003.

### 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 opinion 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 1, 2003



United States Department of State  
 Chief Financial Officer  
 Washington, D.C. 20520-7427

February 1, 2003

MEMORANDUM

TO:                   OIG – Mr. Clark Kent Erwin

FROM:               RM – Christopher B. Burnham 

SUBJECT:           Draft Audit Report on the Department of State's 2002 and 2001  
 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 2002 and 2001 Principal Financial Statements" (Report). For the sixth 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. Achieving an unqualified opinion by the February 1 due date is an important accomplishment for both of our offices. We would 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 2002 and prior years.

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 and 2002 the Department continued to improve the information systems security program. The Department is currently working on a comprehensive plan that will have systems certified and accredited by the end fiscal year 2004. 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.

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. We will continue to 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 2003 Report.

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 2001. As noted in your report RM has completed several phases of 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 continue to be on schedule for completion of RFMS by September of this year.

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 over the past two years. The Unliquidated Obligation System was implemented in FY 2000. We use this system 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. These processes will be repeated and expanded upon during FY 2003. 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 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 necessary for budgeting information and performance measurement, the Department is developing a Central Financial Planning System (CFPS). Phase 4 of CFPS, scheduled for September of 2003 and is included in our FFMIA Remediation Plan, will enable the timely and accurate reporting of cost information and associate that information with budget and strategic goals.

We thank you for the opportunity to comment on the draft report and for working with us in a collaborative manner on the FY 2002 financial statements. We believe that our offices have made considerable progress over the past several 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.