



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

September 20, 2005

Mr. Sid L. Kaplan
Acting Assistant Secretary and Chief Financial Officer
Department of State

The Honorable Howard J. Krongard
Inspector General
Department of State

Subject: *Financial Audit: Restatements to the Department of State's Fiscal Year 2003 Financial Statements*

As you know, the Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required to annually prepare and submit audited financial statements of the U.S. government to the President and Congress. We are required to audit these consolidated financial statements (CFS) and report on the results of our work.¹ An issue meriting concern and close scrutiny that emerged during our fiscal year 2004 CFS audit was the growing number of Chief Financial Officers (CFO) Act agencies that restated² certain of their financial statements for fiscal year 2003 to correct errors.³ Errors in financial statements can result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. Further, when restatements do occur, it is important that financial statements clearly communicate and readers of the restated financial statements understand that the financial statements originally issued by management in the previous year and the opinion thereon should no longer

¹The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. § 331 (e). The federal government has elected to include certain financial information on the legislative and judicial branches in the CFS as well.

²A financial statement restatement occurs when an entity either voluntarily or prompted by its auditors or regulators revises public financial information that has previously been reported.

³According to Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, prior period financial statements presented should be restated only to correct errors that caused such statements to be materially misstated.

be relied on and instead the restated financial statements and related auditor's opinion should be used.

Eleven of the 23 CFO Act agencies⁴ restated certain of their financial statements for fiscal year 2003. Five CFO Act agencies had restatements in fiscal year 2003 covering their fiscal year 2002 financial statements. Three CFO Act agencies had restatements covering both years. We noted that the extent of the restatements to CFO Act agencies' fiscal year 2003 financial statements varied from agency to agency, ranging from correcting two line items on an agency's balance sheet to correcting numerous line items on several of another agency's financial statements. In some cases, the net operating results of the agency were affected by the restatement. The amounts of the agencies' restatements ranged from several million dollars to more than \$91 billion.

Nine of the 11 agencies that had restatements for fiscal year 2003 received unqualified opinions on their originally issued fiscal year 2003 financial statements. The auditors for 6 of these 9 agencies issued unqualified opinions on the restated financial statements, replacing the previous unqualified opinions on the respective agencies' original fiscal year 2003 financial statements. The auditors for 2 of these 9 withdrew their unqualified opinions on the fiscal year 2003 financial statements and issued other than unqualified opinions on the respective agencies' restated fiscal year 2003 financial statements because they could not determine whether there were any additional misstatements and the effect of any such misstatements on the restated fiscal year 2003 financial statements. For the remaining agency, the principal auditor of the agency's fiscal year 2004 financial statements was not the principal auditor of the agency's fiscal year 2003 financial statements, and an audit opinion on the agency's restated fiscal year 2003 financial statements was not issued.

Our review focused on the 9 agencies with restatements for fiscal year 2003 that received unqualified opinions on their originally issued fiscal year 2003 financial statements.⁵ These were the Department of Agriculture, Department of State (State), Department of Justice, Department of Transportation, Department of Health and Human Services, General Services Administration, National Science Foundation, Nuclear Regulatory Commission, and Office of Personnel Management.

Because of the varying nature and circumstances surrounding the restatements, we are issuing a number of separate reports on the matter. This report communicates our observations regarding State's fiscal year 2003 restatements. Going forward, we

⁴The Federal Emergency Management Agency (FEMA) was transferred to the Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA was no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for the remainder of fiscal year 2003 and for fiscal year 2004. The DHS Financial Accountability Act, Pub. L. No. 108-330, 118 Stat. 1275 (October 16, 2004), added DHS to the list of CFO Act agencies, increasing the number of CFO Act agencies again to 24 beginning in fiscal year 2005.

⁵The 2 agencies that had restatements for fiscal year 2003 but did not receive unqualified opinions on their originally issued fiscal year 2003 financial statements were the Department of Defense and the Small Business Administration.

hope that the lessons learned from the fiscal year 2003 restatements, together with our recommendations, (1) help State avoid the need for restatements to its future financial statements and (2) help ensure that State's auditor applies appropriate auditing procedures for journal voucher entries in the Bureau of International Organizations unfunded and funded liabilities accounts, which is where the original fiscal year 2003 financial statements were subsequently found to have been misstated.

We reviewed four key areas with respect to the restatements of State's fiscal year 2003 financial statements: (1) the nature and cause of the errors that necessitated the restatements, including planned corrective actions by the agency and its auditors; (2) the timing of communicating the material misstatement to users of the financial statements; (3) the extent of transparency⁶ exhibited in disclosing the nature and impact of the material misstatement in the financial statements and the reissued auditor's report; and (4) audit issues that contributed to the failure to detect the errors that necessitated the restatements during the audit of the agency's fiscal year 2003 financial statements.

Results in Brief

Failure to properly record journal voucher entries for two large transactions that together accounted for most of a \$927 million error and inadequate management review of these journal vouchers to detect the improper entries led to the material error that necessitated State's restatements of certain of its fiscal year 2003 financial statements. We determined that State's auditor did not detect the errors because the fiscal year 2003 audit tests performed by the auditor were not designed to detect journal voucher entry errors for the affected accounts. In addition, the title of State's note disclosure of the restatements could be misinterpreted.

We are making a recommendation to State's Acting CFO to address the issues we identified with respect to the journal voucher errors that necessitated the fiscal year 2003 restatements. We are also making a recommendation to State's Inspector General to work with the contracted independent public accountant (IPA) to ensure that audit tests to detect any similar journal voucher errors in the future are implemented.

In commenting on a draft of this report, State's Acting CFO stated that his office agrees with our recommendation for management to evaluate whether State's new journal voucher review procedures are effective and that State is currently reviewing the effectiveness of these procedures. State's Inspector General concurred with our recommendation and stated that his office will work with the IPA to implement audit

⁶Transparency is the full, accurate, and timely disclosure of information.

steps in conformance with the *Financial Audit Manual* (FAM)⁷ to test journal vouchers in the Bureau of International Organizations unfunded and funded liabilities accounts. We also received technical comments from State's Acting CFO and Inspector General, which we have incorporated as appropriate.

Background

In conducting the fiscal year 2004 audit of the CFS, we reviewed the 23 CFO Act agencies' performance and accountability reports for possible restatements and identified 11 agencies that had restated certain of their audited fiscal year 2003 financial statements.

The primary intended users of federal agencies' financial reports are citizens, Congress, federal executives, and federal program managers.⁸ Each of these groups may use federal agencies' financial statements to satisfy their specific needs. Citizens are interested in many aspects of the federal government, particularly federal programs that affect their financial well-being. Congress is interested in monitoring and assessing the efficiency and effectiveness of federal programs. Federal executives, such as central agency officials at OMB and the Department of the Treasury (Treasury), are interested in federal financial statements to assist the President of the United States. OMB assists the President in overseeing the preparation of the federal budget by formulating the President's spending plans, evaluating the effectiveness of agency programs, assessing competing funding demands among agencies, and setting funding priorities. Treasury assists the President in managing the finances of the federal government and prepares the CFS, which is based on audited financial statements prepared by federal agencies. GAO audits the CFS and reports on the results of its audit. Finally, federal program managers use agency financial statements as tools for managing their operations within the limits of the spending authority granted by Congress.

The primary accounting and auditing standards that apply to restatement disclosures by federal entities are the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, and the American Institute of Certified Public Accountants (AICPA) Codification of Auditing Standards, AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.⁹

⁷GAO/President's Council on Integrity and Efficiency, *Financial Audit Manual*, GAO-01-765G (Washington, D.C.: July 2001), updated by GAO-04-1015G and GAO-04-942G (July 2004).

⁸Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*.

⁹Generally accepted government auditing standards incorporate AICPA reporting and auditing standards unless the Comptroller General of the United States excludes them by formal announcement.

Objective, Scope, and Methodology

The objective of our review of restatements of State's fiscal year 2003 financial statements was to determine the nature and cause of the errors, the transparency and timing of communicating the material misstatements, any audit issues relating to such misstatements, and any actions being taken to help preclude similar errors from occurring in the future.

We reviewed the nature and causes of the restatements, and we also examined corrective actions taken by State to help preclude similar errors from occurring in the future. We interviewed the preparers and auditors of State's fiscal year 2003 financial statements, including staff from the agency's Office of Inspector General (OIG), and we obtained and reviewed relevant audit documentation.

In our review, we considered certain accounting and auditing standards, including SFFAS No. 21; the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 16, *Prior Period Adjustments*; and the AICPA Codification of Auditing Standards, AU section 420, *Consistency of Application of Generally Accepted Accounting Principles*, AU section 508, *Reports on Audited Financial Statements*, and AU section 561.

We performed our review of the restatements of State's fiscal year 2003 financial statements from December 2004 to July 2005 in accordance with U.S. generally accepted government auditing standards.

We requested comments on a draft of this report from State's Acting CFO and Inspector General or their designees. Written comments from State's Acting CFO and Inspector General are reprinted in enclosures I and II, respectively, and are also discussed in the Agency Comments section.

Issues Related to Restatement of Certain of State's Fiscal Year 2003 Financial Statements

With respect to the restatement of certain of State's fiscal year 2003 financial statements, we identified the following three areas that need improvement: (1) review of journal voucher transactions for the Bureau of International Organizations accounts, (2) design of journal voucher audit steps for the Bureau of International Organizations accounts, and (3) the title of the note disclosure of the restatements. These issues are discussed in detail below.

Bureau of International Organizations Journal Voucher Transactions Were Not Sufficiently Reviewed

Certain of State's financial statements for fiscal year 2003 were restated to reflect activity related to approximately \$927 million in liabilities incurred by the department's Bureau of International Organizations. Specifically, in connection with recording two large transactions in fiscal year 2003 that involved the reclassification

of certain liabilities as funded liabilities from unfunded liabilities, a State official informed us that State failed to record the companion proprietary¹⁰ journal entries that are necessary once a liability has been funded. As a result, Unexpended Appropriations—Used was overstated by approximately \$927 million, and Expended Appropriations was understated by approximately \$927 million. The overall effect of the errors was that the amounts for Unexpended Appropriations and Cumulative Results of Operations on the originally issued fiscal year 2003 Balance Sheet and fiscal year 2003 Statement of Changes in Net Position were materially overstated and understated, respectively, by \$927 million.

State officials discovered the fiscal year 2003 errors in late October 2004, during State's year-end analysis of the fiscal year 2004 financial statements. Through analytical procedures and research, State observed inconsistencies between the unfunded and funded liabilities accounts. Following the discovery, State informed its IPA of the errors, which was appropriate. State completed its analysis of the errors on November 10, 2004. According to State, two incorrectly entered journal vouchers primarily caused the errors.

Although State had a process for reviewing journal vouchers, it was not followed in the case of these two journal vouchers. The process called for a supervisor to approve journal vouchers before they were entered into the general ledger. According to a State official, however, the erroneous journal vouchers were not reviewed by a supervisor before they were entered into the accounting system. According to another State official, prior to the discovery of these errors, State took steps to improve its journal voucher postings by strengthening its journal voucher review process. Specifically, accounting personnel who create journal vouchers are now required to have a coworker review and sign the journal voucher before forwarding it for supervisory approval. The Director or Deputy Director of Financial Reporting and Analysis is then required to enforce compliance with the approval process by reviewing the approved journal vouchers—including determining that they have been signed by a supervisor—before the journal vouchers are entered into the accounting system.

Journal Voucher Audit Steps Did Not Detect Errors in the Bureau of International Organizations Accounts

The above-noted accounting breakdown was not discovered during the audit of the department's fiscal year 2003 financial statements because the fiscal year 2003 audit tests performed by State's IPA were not designed to detect journal voucher errors in the Bureau of International Organizations unfunded and funded liabilities accounts.

The FAM states that during the audit planning process, the auditor should identify conditions that significantly increase inherent, fraud, and control risk. Among other

¹⁰Proprietary accounts provide the information for the financial statements based on Federal Accounting Standards Advisory Board standards and are intended to provide an economic, rather than a budgetary, measure of operations and resources.

things, the auditor should perform procedures to identify account balances and transactions that might signal inherent risk. According to FAM 260.40, to detect evidence of possible material misstatement due to fraud, the auditor should examine journal entries and other adjustments, including reclassifications, consolidating entries, and other routine and nonroutine journal entries and adjustments. This section of the FAM also states that the auditor should obtain an understanding of the financial reporting process and the controls over journal entries and other adjustments; identify and select journal entries and other adjustments for testing; determine the nature, timing, and extent of the testing; and inquire of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and adjustments. If the IPA had identified the journal vouchers involving the Bureau of International Organizations accounts as presenting increased inherent, fraud, or control risk and had then followed the above-noted FAM procedures, the errors that necessitated the restatements might have been detected.

According to State's OIG, future audit tests will be designed to detect any material journal voucher errors in the Bureau of International Organizations unfunded and funded liabilities accounts.

The Title of State's Note Disclosure of the Restatements Could Be Misinterpreted

The notes to State's comparative fiscal years 2004 and 2003 financial statements included a note disclosure titled "Prior Period Adjustment." This title could be misinterpreted, since the note disclosure discussed the adjustment to correct the \$927 million material misstatement and the adjustment represented a restatement rather than a prior period adjustment as defined by SFFAS No. 21.

Conclusions

The restatements were caused by an error that State identified. State corrected the error and issued restated financial statements. Going forward, the key will be for State to ensure that the planned corrective actions to address the cause of the error are fully and effectively implemented. In addition, it will be important that State's OIG work with State's IPA to ensure that audit tests to detect any similar errors in the future are fully and effectively implemented.

Recommendations for Executive Action

We recommend that State's Acting CFO determine whether the new journal voucher review procedures established to ensure adequate review of Bureau of International Organizations journal voucher transactions are being fully and effectively implemented.

We recommend that State's Inspector General work with State's IPA to ensure that audit tests in conformance with the FAM to test journal vouchers in the Bureau of

International Organizations unfunded and funded liabilities accounts are fully and effectively implemented.

Agency Comments

In commenting on a draft of this report, State's Acting CFO stated that his office agrees with our recommendation for management to evaluate whether State's new journal voucher review procedures are effective and that State is currently reviewing the effectiveness of these procedures. State's Inspector General concurred with our recommendation and stated that his office will work with the IPA to implement audit steps in conformance with the FAM to test journal vouchers in the Bureau of International Organizations' unfunded and funded liabilities accounts. We also received technical comments from State's Acting CFO and Inspector General, which we have incorporated as appropriate.

Within 60 days of the date of this report, we would appreciate receiving a written statement on actions taken to address these recommendations.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Homeland Security and Governmental Affairs; the Subcommittee on Federal Financial Management, Government Information, and International Security, Senate Committee on Homeland Security and Governmental Affairs; the House Committee on Government Reform; and the Subcommittee on Government Management, Finance and Accountability, House Committee on Government Reform. In addition, we are sending copies to the Fiscal Assistant Secretary of the Treasury and the Controller of OMB. This report is also available at no charge on GAO's Web site at www.gao.gov.

We appreciate the courtesy and cooperation extended to us by your staff throughout our work. We look forward to continuing to work with your offices to help improve financial management in the federal government. If you have any questions about the contents of this report, please contact me at (202) 512-3406 or engelg@gao.gov.



Gary T. Engel
Director
Financial Management and Assurance

**Enclosure I: Comments from the Acting Assistant Secretary and Chief
Financial Officer, Department of State**



United States Department of State

Assistant Secretary and Chief Financial Officer

Washington, D.C. 20520

SEP 13 2005

Gary T. Engel, Director
Financial Management and Assurance
Government Accountability Office
441 G Street, NW
Room 5476
Washington, DC 20548

Dear Mr. Engel:

We appreciate the opportunity to comment on the Government Accountability Office's (GAO) draft report entitled *Financial Audit: Restatements to the Department of State's Fiscal Year 2003 Financial Statements*, dated August 2005.

We agree with your recommendations for management to evaluate whether our new journal voucher (JV) review procedures are effective. In that regard, we have strengthened controls over this process and are currently reviewing the effectiveness of these procedures.

If you have questions or require additional information, please contact Sheila Conley, Managing Director, Financial Policy Reporting and Analysis, at (202) 663-1447.

Sincerely,

A handwritten signature in black ink, appearing to read "S. Kaplan", written over a horizontal line.

Sid L. Kaplan, Acting

Enclosure II: Comments from the Inspector General, Department of State



United States Department of State
and the Broadcasting Board of Governors

Inspector General

August 31, 2005

Gary T. Engel, Director
Financial Management and Assurance
Government Accountability Office
441 G Street, NW
Room 5476
Washington, DC 20548

Dear Mr. Engel:

The Office of Inspector General (OIG) appreciates the opportunity to comment on the Government Accountability Office's (GAO) draft report entitled *Restatements to the Department of State's Fiscal Year 2003 Financial Statements*, dated August 2005.

Based on GAO's agreement to incorporate the technical changes OIG communicated to it on August 31, OIG concurs with GAO's recommendation. OIG will work with the independent public accountant to implement audit steps in conformance with the Financial Audit Manual to test journal vouchers in the Bureau of International Organizations' unfunded and funded liabilities accounts.

If you have any questions or need any additional information, please contact Mark W. Duda, Assistant Inspector General for Audits, at (202) 663-0372 or Gayle Voshell, Director of the Financial Management Division, at (703) 284-2698.

Sincerely,

A handwritten signature in black ink that reads "Howard J. Krongard".

Howard J. Krongard
Inspector General

cc: RM – Mr. Sid L. Kaplan, Acting
RM/DCFO – Mr. Chris H. Flaggs
RM/GAO – Ms. Julianne Shinnick
Leonard G. Birnbaum and Company, LLP – Mr. Leslie A. Leiper

Address correspondence to: U.S. Department of State, Office of Inspector General, Washington, D.C. 20522-0308

(198364)

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.