CHAPTER 3:

Auditors' Reports and Financial Statements

MESSAGE FROM THE CHIEF FINANCIAL OFFICER

I am pleased to present the Nuclear Regulatory Commission's financial statements for FY 2004. Our independent auditor has rendered an unqualified opinion on our FY 2004 financial statements, attesting to the fact that the Nuclear Regulatory Commission's financial statements are fairly presented. We restated our FY 2003 financial statements to reflect approximately $3 million underbilling in fees to licensees and $777 thousand in capital leases not previously recorded. The auditor found the restated FY 2003 statements to be fairly presented, except for adjustments, if any, due to the lack of evidence supporting the completeness of accounts receivable and revenue.

As of September 30, 2004, the financial condition of the Nuclear Regulatory Commission is sound with respect to having sufficient funds to meet its mission and having sufficient internal controls in place to ensure its budget authority is not exceeded. We successfully collected $545.3 million in fees paid by licensees, or approximately 100 percent of the agency's budget that is subject to fee recovery. Our year-end delinquent debt was only $0.9 million, significantly less than our goal of one-half of one percent of the fees collected. Payments to commercial vendors were made on time 94 percent of the time, and 99 percent of our payments were made electronically. Improper payments were limited to less than $150,000, less than one-half of one percent of payments made.

Through the efforts and teamwork of program, financial management, and audit staff, we continue to be successful in achieving our goals and ensuring that our operations provide timely and reliable information that is used to promote results, accountability, and efficiency. For FY 2004, corrective actions were completed on three reportable conditions and closed by the auditors, quarterly financial statements were issued 15 days after the end of the quarter, and our FY 2004 *Performance and Accountability Report* is being published by November 15, 2004. In addition, the agency examined the adequacy of its efforts to protect against waste, fraud, and mismanagement and the adequacy of its financial systems. Our assessment revealed that we need to strengthen our Fee Billing System. We will develop and implement a remediation plan to correct the deficiency in FY 2005.

Auditors' Reports and Financial Statements

The Nuclear Regulatory Commission is committed to effective and efficient management of agency resources and continued pursuit of the President's Management Agenda. Our goals and strategies for improving financial management are centered on maintaining an unqualified audit opinion, eliminating the material internal control weakness and substantial non-compliance, meeting new requirements, and implementing E-Government initiatives. We are also addressing reportable conditions identified by the auditor in their review of the financial statements.

I anticipate another productive year in 2005 and continuation of the same high level of quality financial services that resulted in our past successes. While we make progress, we are mindful of our support role in achieving an unqualified audit opinion on the Financial Report of the United States Government.

Jesse L. Funches
November 15, 2004

United States
Nuclear Regulatory Commission
Washington, D.C. 20555-0001

OFFICE OF THE
INSPECTOR GENERAL

November 12, 2004

MEMORANDUM TO: Chairman Diaz

FROM: Hubert T. Bell
Inspector General

SUBJECT: RESULTS OF THE AUDIT OF THE U.S. NUCLEAR REGULATORY COMMISSION'S FINANCIAL STATEMENTS FOR FISCAL YEARS 2004 AND 2003 (OIG-05-A-02)

This memorandum transmits the R. Navarro & Associates, Inc., Independent Auditors' Report on the audit of the Nuclear Regulatory Commission's (NRC) financial statements for the fiscal years ended September 30, 2004, and 2003. The Chief Financial Officers Act of 1990, as amended, (CFO Act) requires the Inspector General (IG) or an independent external auditor, as determined by the IG, to annually audit NRC's financial statements in accordance with applicable standards. R. Navarro & Associates' report includes: (1) an opinion on the financial statements, (2) a report on the effectiveness of internal controls, and (3) a report on compliance with laws and regulations.

Objective of a Financial Statement Audit

The objective of a financial statement audit is to determine whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation.

R. Navarro & Associates' examination was made in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. The audit included obtaining an understanding of the internal controls over financial reporting and testing and evaluating the design and operating effectiveness of the internal controls. Because of inherent limitations in any internal control, there is a risk that errors or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate. The risk of fraud is inherent to many of NRC's programs and operations.

Results of Audit

The results are as follows:

Financial Statements

- FY 2004 - Unqualified opinion
- FY 2003 - Opinion changed from unqualified to qualified due to the lack of evidential matter to support the completeness of accounts receivable and revenue

FY 2004 Internal Controls

- Material Weakness:
  - Fee Billing System
- Reportable Conditions:
  - Monitoring of Accounting for Internal Use Software
  - User Organization Compensating Controls

FY 2004 Compliance with Laws and Regulations

- Reportable Conditions:
  - Part 170 Hourly Rates
  - Fee Recovery from Licensees
  - Fee Billing System - Federal Financial Management Improvement Act of 1996- Substantial Noncompliance

OIG Evaluation of R. Navarro and Associates, Inc. Performance

To fulfill our responsibilities under the CFO Act and related legislation for ensuring the quality of the audit work performed, we monitored R. Navarro & Associates' audit of NRC's Fys 2004 and 2003 financial statements by:

- Reviewing their approach and planning of the audit;
- Evaluating the qualifications and independence of its auditors;
- Monitoring the progress of the audit at key points;
- Examining the workpapers related to planning and performing the audit and assessing NRC's internal control;
- Reviewing R. Navarro & Associates' audit report to ensure compliance with *Government Auditing Standards* and OMB Bulletin No. 01-02;
- Coordinating the issuance of the audit report; and
- Performing other procedures that we deemed necessary.

R. Navarro & Associates is responsible for the attached auditors' report, dated November 10, 2004, and the conclusions expressed therein. The OIG is responsible for technical and administrative oversight regarding the firm's performance under the terms of the contract. Our review, as differentiated from an audit in conformance with *Government Auditing Standards*, was not intended to enable us to express, and accordingly we do not express an opinion on NRC's financial statements, the effectiveness of its internal control over financial reporting, or NRC's compliance with laws and regulations. However, our monitoring review, as described above, disclosed no instances where R. Navarro & Associates did not comply with applicable auditing standards.

Performance Reporting

As required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

Meeting with the Chief Financial Officer

At the exit conference on November 10, 2004, representatives of the Office of the Chief Financial Officer, OIG, and R. Navarro & Associates discussed the issues in the report.

The independent auditors' management letter providing observations on ways to strengthen internal controls and operating efficiency will be sent separately.

We appreciate NRC staff's cooperation and continued interest in improving financial management within NRC.

Attachment: As stated

cc: Commissioner McGaffigan
Commissioner Merrifield

R. NAVARRO
& ASSOCIATES, INC.
CERTIFIED PUBLIC ACCOUNTANTS

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(619) 298-8193

Chairman Nils J. Diaz
U.S. Nuclear Regulatory Commission
Washington, DC

In our audit of the U.S. Nuclear Regulatory Commission (NRC), we found:

- The balance sheet of NRC as of September 30, 2004, and the related statements of net cost, statement of changes in net position, statement of budgetary resources, and statement of financing for the fiscal year then ended are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America;

- The balance sheet of NRC as of September 30, 2003, as restated, and the related restated statement of net cost, statement of changes in net position, statement of budgetary resources, and statement of financing for the fiscal year then ended are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America, except for adjustments, if any, due to the lack of evidence to support the completeness of accounts receivable and revenue;

- Except for the material weakness over the Fee Billing System, the effectiveness of internal control over financial reporting was fairly stated as of September 30, 2004, in compliance with the internal control objectives in the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. The Bulletin requires that transactions be properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and that assets be safeguarded against loss from unauthorized acquisition, use or disposal; and

- The NRC continues to be non-compliant with the provisions of OMB Circular A-25, *User Charges*, for Part 170 fees and a Fee Recovery condition. Additionally, we identified a substantial non-compliance related to the Fee Billing System.

The following sections outline each of these conclusions in more detail.

Auditors' Reports and Financial Statements

INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of NRC as of September 30, 2004, and 2003, and the related statements of net cost, statements of changes in net position, statements of budgetary resources, and statements of financing for the fiscal years then ended. These financial statements are the responsibility of NRC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Matters of Emphasis

Classification of Costs

OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, provides guidance to federal agencies for presenting program costs classified by intragovernmental and public components. The basis for classification relies on the concept of who received the benefits of the costs incurred (e.g. private sector licensees versus federal licensees) rather than who was paid. However, following the advice of OMB, NRC classified the costs on the Statement of Net Cost using an underlying concept of who was paid. Furthermore, OMB Bulletin No. 01-09 requires that the Statement of Net Cost be presented using full program costs by output. The agency presents its costs aggregated by mission-related strategic arenas, which are comprised of NRC's programs.

U.S. Department of Energy Expenses

NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. NRC's Statements of Net Cost include approximately $77.2 and $73.1 million, respectively for the years ended September 30, 2004, and 2003, of

reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations within NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the Government Accountability Office's (GAO) Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and should provide the results of its audits to NRC.

FY 2003 Financial Statements Restated

The financial statements for FY 2003 were restated to reflect approximately $3 million in fees to licensees due to deficiencies in the agency's fee billing system. Additionally, the balance sheet includes $777 thousand under capital leases acquired by the agency in FY 2002 and not previously recorded, and a reclassification of unfilled customer orders of $4.7 million. Note 13 to the financial statements provides a detailed description of the restatement.

In our report dated November 20, 2003, we expressed an opinion that the FY 2003 financial statements presented fairly the financial position, net cost, changes in net position, budgetary resources, and reconciliation of net costs to budgetary resources for the fiscal year ended September 30, 2003. The NRC made a software change during FY 2003 that precluded the preparation of complete billings to licensees for reactor and fuel fees. The NRC identified unbilled FY 2003 fees of approximately $3 million. The agency billed these fees and subsequently restated the FY 2003 financial statements. However, the agency could not provide sufficient evidence to support the completeness of the accounts receivable balance or revenue. The Fee Billing System used by the agency does not provide for the production of period reports, thus the fee reports produced of FY 2003 transactions would have to be rolled back. The evidence to support such rollback is not readily available. Therefore, we are uncertain of the adjustments, if any, that would have been made to accounts receivable and revenue had evidence been available for audit. Accordingly, our present opinion on the FY 2003 financial statements as presented herein, is different from that expressed in our previous report.

In our opinion, except for the effects on the FY 2003 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the completeness of the restated accounts receivable and revenue amounts as described in the preceding paragraph, the financial statements referred to above and included in NRC's performance and accountability report present fairly, in all material respects, the financial position at September 30, 2004, and 2003, and its net cost, changes in net position, budgetary resources, and reconciliations of net cost to budgetary resources for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

REPORT ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

We have examined the effectiveness of NRC's internal control over financial reporting, as of September 30, 2004, based on the criteria in OMB Bulletin No. 01-02. The Bulletin requires management to establish internal accounting and administrative controls to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and that assets be safeguarded against loss from unauthorized acquisition, use or disposal. NRC's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants (AICPA); the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 01-02. Accordingly, we obtained an understanding of the internal control over financial reporting, tested and evaluated the design and operating effectiveness of internal control, and performed such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

We identified significant deficiencies in the Fee Billing System. The system in place does not meet the requirements of sound internal control over financial reporting as provided in OMB Bulletin No. 01-02, nor is the system's design compliant with the requirements of the Joint Financial Management Improvement Program (JFMIP) for Revenue Systems. We believe such a condition represents a material weakness. A material weakness is a reportable condition that

precludes the NRC's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented and detected on a timely basis.

In our opinion, except for the effect of the material weakness described in the preceding paragraph, NRC has maintained, in all material respects, effective internal control over financial reporting as of September 30, 2004, based on the internal control objectives listed in OMB Bulletin No. 01-02.

Additionally, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the AICPA and OMB Bulletin No. 01-02. A reportable condition is a matter coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the agency's ability to meet the internal control objectives described above. We identified three reportable conditions; NRC needs to: (1) improve the fee billing system, (2) improve monitoring of accounting for internal use software, and (3) implement compensating controls for applications used through a service provider. The Fee Billing System condition is considered a material weakness.

A material weakness, as defined by the AICPA and OMB Bulletin No. 01-02, is a reportable condition 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 misstatements caused by error or fraud in amounts that would be material in relation to the principal 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 believe that the reportable conditions that follow, except for the Fee Billing System, are not material weaknesses as defined by the AICPA and OMB Bulletin No. 01-02.

Fee Billing System

The Omnibus Budget Reconciliation Act (OBRA-90), Public Law 101-508, as amended, requires that NRC recover, through fee billing, a percentage of its budget authority in each fiscal year, less amounts appropriated from the Nuclear Waste Fund (NWF). In FY 2004 the recovery percentage was 92 percent. In order to meet this requirement, the NRC assesses two types of fees to recover its budget authority. Annual fees are assessed under 10 CFR Part 171 for nuclear facilities and materials licensees, commonly known as Part 171 fees. Other fee types include license, inspection and other services, established in 10 CFR Part 170 under the authority of the Independent Offices Appropriation Act (IOAA). The Part 170 fees are assessed to recover the NRC's costs of providing individually identifiable services to specific applicants and licensees.

In order to comply with the requirements of OBRA-90 and IOAA the agency relies on a series of applications that comprise the Fee Billing System. The application configurations vary in order to operationally adapt each system to fit the fee billing type. In FY 2003 the agency implemented software changes to the Fee Billing System that resulted in the understatement of invoices to 54 licensees. While analyzing the universe of FY 2004 fee invoices for sampling purposes, we discovered that 74 FY 2003 invoices were re-issued to recover approximately $2.5 million in previously unbilled reactor inspection fees. Once this issue was identified additional procedures disclosed approximately $500 thousand in additional unbilled invoices related to FY 2003. The FY 2003 financial statements were restated to reflect the understatement of revenue and accounts receivable. This condition is considered a material weakness and Federal Financial Management Improvement Act (FFMIA) substantial non-compliance.

The condition resulted from several deficiencies: (1) inadequate acceptance testing of software modifications, (2) intensive manual processes, and (3) the lack of comprehensive quality assurance procedures over the billing process.

Inadequate Acceptance Testing

In February 2003, the agency placed into production a major software release for FEES, a mainframe system hosted by a service provider. The main purpose of the software release was to implement a new user-friendly interface.

The release also automated data reporting for Nuclear Security and Incident Response (NSIR) and Research (RES). Previously, hours incurred on facility licensing actions and topical reports by personnel in these Headquarters offices were manually input. After the software release was placed in production, data from Headquarters offices continued to be captured and retained in FEES but the interface between FEES and FACFEES did not transfer data to FACFEES (a PC based system running on the NRC LAN and used to generate facility inspection billings for data maintained in FEES).

The acceptance testing performed failed to discover deficiencies because the interface was not tested to ensure that all inspection data from Headquarters and regional offices was appropriately transferred to FACFEES. This failure illustrates the need for more rigorous testing of interfaces before major releases of software are placed in production.

The Standards for Internal Control in the Federal Government, issued by the Government Accountability Office, prescribe that control activities should be effective and efficient in accomplishing the agency's control objectives. Control activities for IT systems should provide the structure for safely developing new systems and modifying existing systems, including reviews, testing and approvals of development and modification activities before placing systems into operation.

Intensive Manual Processes

The agency relies on a small team to prepare, review and issue billings on a monthly and quarterly basis. The License Fee Team (LFT) employs various manual processes to compensate for the lack of flexibility in the legacy fee billing system. The system does not have the ability to give the agency drill down capacity to review billing questions. Instead LFT personnel must set aside other priorities to perform manual research of a problem. The system does not provide automated audit trails from the initial source of the transaction (i.e. inspection hours) to the development of an invoice. LFT personnel undertake a process where they have to recreate what happened to the best of their personal cuff records and knowledge. This is of particular concern since the fee billing system is not date sensitive; therefore, reports produced are as of the print date rather than the transaction date.

The lack of system functionality coupled with the age of the system and its reliance on manual intervention resulted in an FFMIA substantial non-compliance with the JFMIP Revenue System Requirements. The agency has begun the planning process for redesigning or replacing the billing system with the tools and technology of the present.

Lack of Comprehensive Quality Assurance Procedures

In mid to late FY 2004, the OCFO developed informal procedures to detect potential under billings. However, these procedures are not effective because they do not provide for global reconciliations of FEES reports to billings generated by the PC based billing system. Global reconciliations of data generated by different sources are necessary to identify differences that may prompt action preventing the preparation and issuance of erroneous licensee invoices. Additionally, some reports produced by the fee system do not contain control totals to enable comparisons of invoices to raw data sources, thus complicating the viability of a quality assurance process.

The *Standards for Internal Control in the Federal Government*, state "Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations. It is performed continually and is ingrained in the agency's supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties."

Recommendation

1. The CFO should ensure that the functionality of interfaces is rigorously tested before placing any software changes into production. Acceptance testing scripts should be designed more broadly to ensure greater scrutiny of the change being implemented. Independent validations of software changes and the related acceptance testing should be performed or reviewed and approved by persons other than those requesting the software modifications.

2. The CFO should develop and implement a remediation plan to enhance the reliability of the current billing system. Additionally, as the CFO considers the system redesign they should identify steps to address systemic issues with the current fee billing system.

3. The CFO should ensure that documented, complete, and reliable quality assurance procedures are prepared for the billing process. At a minimum, those procedures should provide for a documented global reconciliation, at each billing cycle, of hours and fees reflected in FEES to the invoices generated by the PC based fee billing systems.

MONITORING OF ACCOUNTING FOR INTERNAL USE SOFTWARE

As reported in FY 2002, the Federal Accounting Standards Advisory Board issued Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software*, effective October 1, 2000. SFFAS No. 10 defines three software life-cycle phases: planning, development and operations. Paragraph 16 requires, "For internally developed software, capitalized cost should include the full cost (direct and indirect cost) incurred during the development phase." The Statement defines full cost to include salaries of programmers, project managers, administrative personnel, and associated employee benefits and outside consultants' fees.

Since FY 2002, we have identified the lack of proactive management of the costs incurred for internal use software as a reportable condition. OCFO's management control structure is designed to rely heavily on project managers to inform OCFO of time and costs expended in the software development phase. OCFO has not fully addressed execution of existing monitoring procedures to ensure the completeness or reasonableness of the project manager's information.

Our review of the agency's practices for accounting for internal use software projects, continues to identify the following inconsistencies:

- Contractor costs incurred on projects were not being routinely captured and capitalized;
- Project managers were not coding their time appropriately during the development phase of their projects;
- Project managers did not receive training and thus were not fully aware that time and costs should be captured and reported to OCFO; and
- Labor certifications were not being completed, signed and/or were being completed late.

For example, beginning in August 2003 the NRC spent approximately $1.2 million in modifying the Operations Center Management Information System. The OCFO did not become aware of the project until a survey was performed by the Office of the Chief Information Officer in July 2004. The project costs were invested in equipment and software development. Costs subject to capitalization thresholds were approximately $642 thousand. These exceptions continue to indicate that the agency does not have a routine, timely, and disciplined process in place to monitor the adequacy of accounting information necessary to capitalize internal use software projects.

Recommendation

4. The CFO should continue to reassess the internal use software procedures and related accounting activities being undertaken by agency personnel to ensure their completeness and propriety. In addition to proactive monitoring, the CFO should design and provide training to project managers and their supervisors in order to provide awareness and instill discipline to project managers in their role of providing reliable information to the OCFO.

USER ORGANIZATION COMPENSATING CONTROLS

In response to the President's Management Agenda for E-Government initiatives, NRC migrated to the Federal Personnel and Payroll System (FPPS) operated by the National Business Center (NBC), Department of Interior, as a service bureau. The migration occurred in November 2003.

NBC designed the controls over FPPS under the assumption that client organizations would implement effective controls to complement FPPS controls. The FPPS service auditors' report lists the user controls necessary to achieve the control objectives specified by NBC. In addition to several other controls, NBC recommends that user organizations should implement controls to ensure that payroll costs are reconciled for accuracy.

NRC's procedures are not designed to detect misstatements made during payroll processing. Presently, the following reconciliation process is followed:

- Payroll data is downloaded from FPPS into Federal Financial System, the agency's general ledger system.
- Imported data is reconciled to the FPPS cost reports for each payroll period.
- Each month, OCFO reconciles FPPS data to information recorded in FFS.
- OCFO compares cost information reported by NBC to the U.S. Treasury on the monthly Statements of Transactions (SF-224) to the payroll costs recorded in FFS.

These reconciliation procedures are designed to provide reasonable assurance that information transferred into the agency's general ledger and that disbursed by the Treasury are reliable. However, there are no compensating controls to validate the reliability of the payroll amounts processed by FPPS. NRC is accepting as correct the information being transferred into the general ledger without independently assessing the information submitted by the service provider.

NRC Management Directive 4.4, Part 1 provides the implementing policy of the Federal Managers' Financial Integrity Act. The directive states that the proper stewardship of Federal resources is a fundamental responsibility of NRC managers and staff. The Integrity Act requires executive agencies to establish controls to provide reasonable assurance that obligations and costs comply with applicable law; assets are safeguarded against waste, loss, unauthorized use or misappropriation; and revenues and expenditures are properly recorded and accountability is maintained.

Recommendation

5. The CFO should develop compensating controls to assist in validating information provided by NBC. At a minimum, the agency should develop an expectation model based on analytical procedures designed to detect misstatements in the biweekly payroll amounts reported by NBC. The CFO should also ensure that the agency is compliant with the list of compensating controls included in the FPPS' service auditors' report.

Status of Prior Year Comments

In the prior year we included conditions related to managerial cost accounting, information security access controls, contract close-out procedures, internal use software monitoring, and compliance with Part 170 Hourly Rates. Corrective actions implemented during the year closed three conditions. However, the conditions related to monitoring of accounting for internal use software and Part 170 Hourly Rates continued in the current fiscal year.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We conducted our audit for the year ended September 30, 2004, in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02.

NRC management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of applicable 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 No. 01-02, including the requirements in the FFMIA. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to NRC. The results of our tests of compliance disclosed noncompliances with laws and regulations that are required to be reported under *Government Auditing Standards*, OMB Bulletin No. 01-02 or under FFMIA.

U.S. Department of Energy Expenses

NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. NRC's Statements of Net Cost include approximately $77.2 and $73.1 million, respectively for the years ended September 30, 2004, and 2003, of reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations within NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the GAO's Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and should provide the results of its audits to NRC.

The objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions of laws and regulations and, accordingly, we do not express such an opinion.

In the current year we identified a continuing noncompliance, which was initially reported in 1998, and two additional reportable conditions. The following discussion addresses the noncompliances:

Part 170 Hourly Rates

As previously reported from FY 1998 through FY 2003, the Omnibus Budget Reconciliation Act (OBRA) of 1990 requires the NRC to recover approximately 100 percent of its budget authority by assessing fees. (The recovery percentage has been reduced in recent years by 2 percent each year. During FY 2004, the recovery percentage was 92 percent.) Accordingly, NRC assesses two types of fees to its licensees and applicants. One type, specified in 10 CFR Part 171, consists of annual fees assessed to power reactors, materials and other licensees. The other type, specified in 10 CFR Part 170 and authorized by the Independent Offices Appropriation Act of 1952, is assessed for specific licensing actions, inspections and other services provided to NRC's licensees and applicants.

Each year, the OCFO computes the hourly rates used to charge for Part 170 services. Consistent with OBRA of 1990, the rates are based on budgetary data and are used to price individually identifiable Part 170 services. NRC developed the FY 1998 and subsequent years' rates using the budgetary basis without validating the fee amounts to the full cost of providing Part 170 services.

The CFO has been awaiting the implementation of cost accounting to fully address this condition. During the final quarter of FY 2003, the agency achieved compliance with SFFAS No. 4 regarding cost accounting. During FY 2004 the agency started an assessment to address this noncompliance. The assessment strategy is being performed on an incremental basis and as of the end of our fieldwork, the preliminary pilot component of the assessment is underway.

Recommendation

6. The CFO should continue to pursue the assessment strategy that is underway and ensure that a communication process is developed to assist OCFO management and to inform the Office of Inspector General of the progress and actions planned to resolve this condition.

Fee Recovery from Licensees

The NRC has a process to assign codes (i.e., billable and non-billable) to contract costs that are fee recoverable. The codes are assigned by project managers in the office that directly manages the effort. During FY 2004, the OCFO determined that contract costs incurred by the Office of

Nuclear Materials Safety and Safeguards (NMSS) for design, construction, operation and deactivation of the Mixed Oxide (MOX) fuel fabrication facility were not billed directly to the licensee. The agency determined that this error, which dates back to FY 2001, affected contract costs totaling $2.1 million. Since the costs had not been properly coded the agency's calculations for fuel facilities fees had been understated. This error did not impact the financial statements since the amounts were recovered, albeit incorrectly from all fuel cycle licensees, rather than the specific licensee.

In the FY 2004 Fee Rule issued in April 2004, the agency made a one-time adjustment to the Fuel Facilities fees for the costs associated with the MOX review. The fee rule explained that the amounts had been improperly coded and not factored into the fee calculations for FY 2001 through FY 2003.

10 CFR Part 170 under the authority of the Independent Offices Appropriation Act (IOAA) requires that fees be assessed to recover the NRC's costs of providing individually identifiable services to specific applicants and licensees.

Recommendation

7. The CFO should develop a process to ensure that new initiatives are effectively monitored to make certain that the agency's financial management guidelines are followed at the start of an initiative. Additionally, the CFO should reiterate to program offices the importance of complying with agency policy to prevent delays in the billing process and to prevent recovering costs from an improper licensee community.

Fee Billing System

In our *Report on the Effectiveness of Internal Control Over Financial Reporting*, we identified the Fee Billing System as both a material weakness and an FFMIA substantial non-compliance. Refer to that report for a detailed discussion of the condition.

INTERNAL CONTROL RELATED TO PERFORMANCE MEASURES

With respect to internal controls related to performance measures described in Chapter 2 of the performance and accountability report, the OIG performed those procedures and will address this issue separately. Our procedures were not designed to provide assurance over reported performance measures, and, accordingly, we do not provide an opinion on such information.

CONSISTENCY OF OTHER INFORMATION

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information included on pages 140 and 141, and the Management Discussion and Analysis, Chapter 1 of this Performance and Accountability Report, is not a required part of the financial statements but is supplementary information required by OMB Bulletin No. 01-09. 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.

The other accompanying information included in Chapter 2 and the appendices to the accountability report, are required by OMB Bulletin No. 01-09 and are presented for purposes of additional analysis and are not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information, Schedule of Intragovernmental Assets and Liabilities and the Schedule of Budgetary Resources, included on pages 140 and 141 of this performance and accountability report, is not a required part of the financial statements but is supplementary information required by OMB Bulletin No. 01-09. This information is also presented for purposes of additional analysis of the financial statements rather than to present the budgetary resources of the NRC programs. This information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report in intended solely for the information and use of NRC management, the Inspector General, OMB, GAO, and the Congress and is not intended to be and should not be used by anyone other than these specified parties.

November 10, 2004

R. Navarro & Associates, Inc.

United States
Nuclear Regulatory Commission
Washington, D.C. 20555-0001

November 11, 2004

MEMORANDUM TO: Stephen D. Dingbaum
Assistant Inspector General for Audits

FROM: Jesse L. Funches
Chief Financial Officer

SUBJECT: AUDIT OF THE FY 2004 FINANCIAL STATEMENTS

I have reviewed the audit report of the agency's FY 2004 Financial Statements, dated November 10, 2004. Our responses to the seven recommendations follow:

Recommendation 1

The CFO should ensure that the functionality of interfaces is rigorously tested before placing any software changes into production. Acceptance testing scripts should be designed more broadly to ensure greater scrutiny of the change being implemented. Independent validations of software changes and the related acceptance testing should be performed or reviewed and approved by persons other than those requesting the software modifications.

Response

Agree. We will ensure any interfaces associated with future software changes are rigorously tested before the change is placed into production.

Recommendation 2

The CFO should develop and implement a remediation plan to enhance the reliability of the current billing system. Additionally, as the CFO considers the system redesign they should identify steps to address systemic issues with the current fee billing system.

CONTACT: Barbara K. Gusack, OCFO/DFM/FSRT
415-6054

Response

Agree. A remediation plan will be developed by April 30, 2005, specifying the schedule and actions that will be taken to improve the reliability of the current fee billing system. We will also continue to develop a replacement fee system and will ensure that it addresses issues associated with the current system.

Recommendation 3

The CFO should ensure that documented, complete, and reliable quality assurance procedures be prepared for the billing process. At a minimum those procedures should provide for a documented global reconciliation, at each billing cycle, of hours and fees reflected in FEES to the invoices generated by the PC based fee billing systems.

Response

Agree. By March 31, 2005, the CFO will modify, document, and implement quality assurance procedures for the billing process. These procedures will include a global reconciliation of each billing cycle. We will also implement interim quality assurance actions for the first quarter FY 2005 billing.

Recommendation 4

The CFO should continue to reassess the internal use software procedures and related accounting activities being undertaken by agency personnel to ensure their completeness and propriety. In addition to proactive monitoring, the CFO should design and provide training to project managers and their supervisors in order to provide awareness and instill discipline to project managers in their role of providing reliable information to the OCFO.

Response

Agree. The CFO will reassess current policies and procedures to improve the completeness and propriety of internal use software capitalization information. We will complete the reassessment by April 30, 2005

Recommendation 5

The CFO should develop compensating controls to assist in validating information provided by NBC. At a minimum, the agency should develop an expectation model based on analytical procedures designed to detect misstatements in the biweekly payroll amounts reported by NBC. The CFO should also ensure that the agency is compliant with the list of compensating controls included in the FPPS' service auditors' report.

Response

Agree. The CFO will review the list of compensating controls listed in the FPPS service auditors' report (SAS-70), and ensure the agency is in full compliance with our user organization role by March 31, 2005. To further ensure the accuracy of payroll payments by NBC, the CFO will modify its current procedures to verify hours paid each pay period. This procedure will be implemented by March 31, 2005. The agency will also evaluate, after gathering further information, the development of an expectation model to help detect misstatements in the biweekly payroll amounts.

Recommendation 6

The CFO should continue to pursue the assessment strategy that is underway and ensure that a communication process is developed to assist OCFO management and to inform the Office of Inspector General of the progress and actions planned to resolve this condition.

Response

Agree.

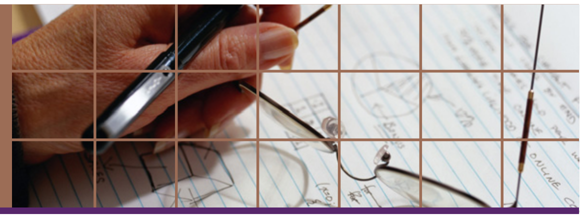
Recommendation 7

The CFO should develop a process to ensure that new initiatives are effectively monitored to make certain that the agency's financial management guidelines are followed at the start of an initiative. Additionally, the CFO should reiterate to program offices the importance of complying with agency policy to prevent delays in the billing process and to prevent recovering costs from an improper licensee community.

Response

Agree. We will develop a process by April 30, 2005, to ensure that the appropriate management and staff are aware of fee-related guidelines and policies. Additionally, by January 31, 2005, the CFO will reiterate to NRC office directors and regional administrators the importance of maintaining compliance with agency fee policy to prevent delays in the billing process and to prevent recovering costs from an improper licensee community.

cc: W. Dean, OEDO
M. Malloy, OEDO



LIMITATIONS OF THE FINANCIAL STATEMENTS

The principal statements have been prepared to report the financial position and results of operations of the NRC, pursuant to the requirements of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. These statements have been prepared from the books and records of the NRC in accordance with the formats prescribed by the Office of Management and Budget. However, these statements differ from the financial reports used to monitor and control budgetary resources that are prepared from the same books and records. The principal statements should be read with the realization that they are for a sovereign entity, liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and the payment of all liabilities other than for contracts can be abrogated by the sovereign entity. Other limitations are included in the footnotes to the principal statements.

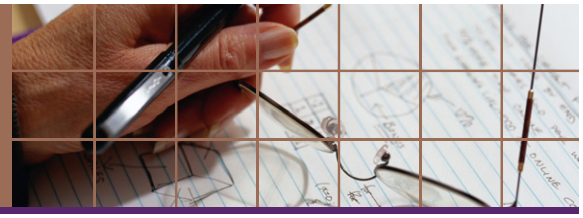
The NRC's FY 2004 financial statements were audited by R. Navarro and Associates, under contract to the NRC's Office of the Inspector General.

BALANCE SHEET

(Dollars in Thousands)

As of September 30,	**2004**	Restated 2003
Assets		
Intragovernmental		
Fund balances with Treasury (Note 2)	**$ 200,277**	$ 193,420
Accounts receivable (Note 3)	**3,357**	2,667
Other	**2,295**	2,933
Total intragovernmental	**205,929**	199,020
Cash and other monetary assets	**-**	20
Accounts receivable, net (Note 3)	**50,648**	50,561
Property and equipment, net (Note 4)	**26,683**	30,205
Other	**29**	19
Total Assets	**$ 283,289**	$ 279,825
Liabilities		
Intragovernmental		
Accounts payable	**$ 8,564**	$ 7,399
Other (Notes 5 and 6)	**61,568**	60,082
Total intragovernmental	**70,132**	67,481
Accounts payable	**19,367**	19,937
Federal employees benefits (Note 6)	**8,114**	9,073
Other liabilities (Note 5)	**48,317**	41,704
Total Liabilities	**145,930**	138,195
Net Position		
Unexpended appropriations	**149,901**	149,719
Cumulative results of operations (Note 8)	**(12,542)**	(8,089)
Total Net Position	**137,359**	141,630
Total Liabilities and Net Position	**$ 283,289**	$ 279,825

The accompanying notes to the principal statements are an integral part of this statement.



STATEMENT OF NET COST

(Dollars in Thousands)

For the year ended September 30,	**2004**	Restated 2003
Nuclear Reactor Safety		
Intragovernmental gross costs	**$ 140,557**	$ 121,025
Less: Intragovernmental earned revenue	**(28,365)**	(25,984)
Intragovernmental net costs	**112,192**	95,041
Gross costs with the public	**309,399**	280,203
Less: Earned revenues from the public	**(447,931)**	(439,693)
Net costs with the public	**(138,532)**	(159,490)
Total Net Cost of Nuclear Reactor Safety	**(26,340)**	(64,449)
Nuclear Materials Safety		
Intragovernmental gross costs	**26,727**	22,270
Less: Intragovernmental earned revenue	**(3,323)**	(4,510)
Intragovernmental net costs	**23,404**	17,760
Gross costs with the public	**68,453**	67,950
Less: Earned revenues from the public	**(51,642)**	(52,148)
Net costs with the public	**16,811**	15,802
Total Net Cost of Nuclear Materials Safety	**40,215**	33,562
Nuclear Waste Safety		
Intragovernmental gross costs	**25,105**	24,780
Less: Intragovernmental earned revenue	**(1,762)**	(1,726)
Intragovernmental net costs	**23,343**	23,054
Gross costs with the public	**75,793**	68,859
Less: Earned revenues from the public	**(16,952)**	(14,305)
Net costs with the public	**58,841**	54,554
Total Net Cost of Nuclear Waste Safety	**82,184**	77,608
International Nuclear Safety Support		
Intragovernmental gross costs	**4,937**	4,951
Less: Intragovernmental earned revenue	**(464)**	(510)
Intragovernmental net costs	**4,473**	4,441
Gross costs with the public	**11,664**	11,103
Less: Earned revenues from the public	**(1,728)**	(1,605)
Net costs with the public	**9,936**	9,498
Total Net Cost of International Nuclear Safety Support	**14,409**	13,939
Net Cost of Operations	**$ 110,468**	$ 60,660

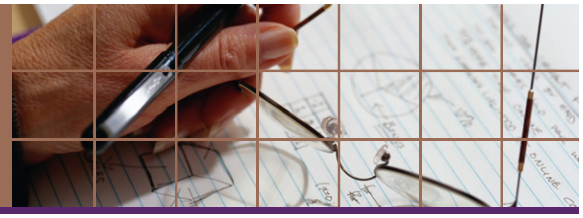
The accompanying notes to the principal statements are an integral part of this statement.

STATEMENT OF CHANGES IN NET POSITION

(Dollars in Thousands)

For the year ended September 30,	**2004**		Restated 2003	
	Cumulative Results of Operations	**Unexpended Appropriations**	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	**$ (8,089)**	**$ 149,719**	$ (474)	$ 128,336
Prior period adjustment			738	(742)
Beginning balances adjusted	**(8,089)**	**149,719**	264	127,594
Budgetary Financing Sources				
Appropriations received		**593,000**	-	560,084
Appropriations transferred-in/out		**(510,439)**	-	(499,119)
Other adjustments		**(280)**	-	(220)
Appropriations used	**82,099**	**(82,099)**	38,620	(38,620)
Non-exchange revenue	**725**	**-**	624	-
Transfers-in/out without reimbursement	**(725)**	**-**	(624)	-
Other Financing Sources				
Imputed financing from costs absorbed by others	**25,129**	**-**	21,978	-
Other	**(1,213)**	**-**	(8,291)	-
Total Financing Sources	**106,015**	**182**	52,307	22,125
Net Cost of Operations	**(110,468)**	**-**	(60,660)	-
Ending Balances	**$ (12,542)**	**$ 149,901**	$ (8,089)	$ 149,719

The accompanying notes to the principal statements are an integral part of this statement.



STATEMENT OF BUDGETARY RESOURCES
(Dollars in Thousands)

For the year ended September 30,	**2004**	Restated 2003
Budgetary Resources		
Budget authority		
Appropriations received	**$ 593,000**	$ 560,084
Net transfers	**32,905**	24,738
Unobligated balances		
Beginning of period	**40,572**	37,346
Spending authority from offsetting collections		
Reimbursements earned	**5,491**	5,337
Change in unfilled customer orders	**1,298**	2,928
Anticipated reimbursement and other income	**-**	-
Total Spending Authority from Offsetting Collections	**6,789**	8,265
Recoveries of prior year obligations	**8,618**	7,386
Permanently not available	**(280)**	(219)
Total Budgetary Resources	**$ 681,604**	$ 637,600
Status of Budgetary Resources		
Obligations incurred (Note 12)		
Direct	**$ 639,322**	$ 590,978
Reimbursable	**5,953**	6,050
Unobligated balance		
Apportioned	**35,282**	39,812
Exempt from apportionment	**1,047**	760
Unobligated balance not available	**-**	-
Total Status of Budgetary Resources	**$ 681,604**	$ 637,600
Relationship of Obligations to Outlays		
Obligated balance, net, beginning of period	**$ 143,934**	$ 136,899
Obligated balance, net, end of period		
Accounts receivable	**(275)**	(598)
Unfilled customer orders from Federal sources	**(3,882)**	(3,317)
Undelivered orders	**117,150**	109,484
Accounts payable	**44,225**	38,365
Obligated balance, net, end of period	**$ 157,218**	$ 143,934
Outlays		
Disbursements	**$ 623,131**	$ 581,020
Collections	**(6,546)**	(6,677)
Subtotal	**616,585**	574,343
Less: Offsetting Receipts	**(545,302)**	(526,273)
Net Outlays	**$ 71,283**	$ 48,070

The accompanying notes to the principal statements are an integral part of this statement.

STATEMENT OF FINANCING
(Dollars in Thousands)

For the year ended September 30,	**2004**	Restated 2003
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations incurred (Note 12)	**$ 645,274**	$ 597,028
Less: Spending authority from offsetting collections and recoveries	**(15,407)**	(15,651)
Obligations Net of Offsetting Collections and Recoveries	**629,867**	581,377
Less: Offsetting receipts	**(545,302)**	(526,273)
Net Obligations	**84,565**	55,104
Other Resources		
Imputed financing from costs absorbed by others	**25,129**	21,978
Allocation transfer	**3,207**	1,576
Other	**(1,213)**	(8,291)
Net Other Resources Used to Finance Activities	**27,123**	15,263
Total Resources Used to Finance Activities	**111,688**	70,367
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided	**(5,074)**	(17,318)
Resources that finance the acquisition of assets	**(5,679)**	(4,844)
Other	**(217)**	588
Total Resources Used to Finance Items not Part of the Net Cost of Operations	**(10,970)**	(21,574)
Total Resources Used to Finance the Net Cost of Operations	**100,718**	48,793
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in the Future Periods		
Increase in annual leave liability	**2,170**	**1,692**
Increase (Decrease) Actuarial Workers' Compensation	**(959)**	11
Increase (Decrease) in Unfunded Workers' Compensation	**10**	(163)
Increase in Unfunded Unemployment	**(5)**	7
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	**1,216**	1,547
Components not Requiring or Generating Resources:		
Depreciation and amortization	**8,534**	10,320
Total Components not Requiring or Generating Resources	**8,534**	10,320
Total Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period	**9,750**	11,867
Net Cost of Operations	**$ 110,468**	$ 60,660

The accompanying notes to the principal statements are an integral part of this statement.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The U.S. Nuclear Regulatory Commission (NRC) is an independent regulatory agency of the Federal Government that was created by the U.S. Congress to regulate the Nation's civilian use of byproduct, source, and special nuclear materials to ensure adequate protection of the public health and safety, to promote the common defense and security, and to protect the environment. Its purposes are defined by the Energy Reorganization Act of 1974, as amended, along with the Atomic Energy Act of 1954, as amended, which provide the foundation for regulating the Nation's civilian use of nuclear materials.

The NRC operates through the execution of its congressionally approved appropriations for salaries and expenses and the Inspector General, including funds derived from the Nuclear Waste Fund. In addition, transfer appropriations are provided by the U.S. Agency for International Development for the development of nuclear safety and regulatory authorities in Russia, Ukraine, Kazakhstan, and Armenia for the independent oversight of nuclear reactors in these countries.

B. Basis of Presentation

These principal statements were prepared to report the financial position and results of operations of the NRC as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. These financial statements were prepared from the books and records of the NRC in conformity with accounting principles generally accepted in the United States of America, the requirements of Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements,* and NRC accounting policies. These statements are, therefore, different from the financial reports, also prepared by the NRC pursuant to OMB directives, which are used to monitor and control NRC's use of budgetary resources.

NRC has not presented a Statement of Custodial Activity because the amounts involved are immaterial and incidental to its operations and mission.

The strategic arenas as presented on the Statement of Net Cost are based on the strategic plans and are described as follows:

Nuclear Reactor Safety which encompasses all NRC efforts to ensure that civilian nuclear power reactor facilities, as well as test and research reactors, are operated in a manner that adequately protects public health and safety and the environment, and that safeguards special nuclear materials used in reactors.

Nuclear Materials Safety which encompasses NRC efforts to ensure that nuclear fuel cycle facilities; and academic, industrial, and medical uses of nuclear materials are handled in a manner that adequately protects public health and safety and the environment, and protects against radiological sabotage and theft or diversion of special nuclear materials.

Nuclear Waste Safety which encompasses NRC efforts to ensure that the decommissioning of nuclear reactors and other facilities, storage of spent nuclear fuel, transportation of radioactive materials, and disposal of radioactive wastes are handled in a manner that adequately protects public heath and safety and the environment, and protects against radiological sabotage and theft or diversion of special nuclear materials.

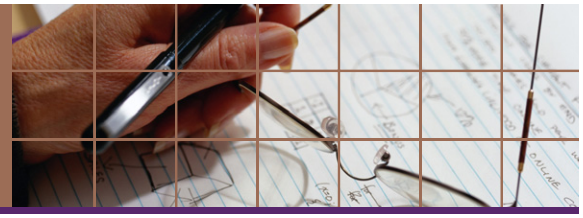
International Nuclear Safety Support which encompasses international nuclear safety and regulatory policy formulation, import-export licensing for nuclear materials and equipment, treaty implementation, and international information exchange.

C. Budgets and Budgetary Accounting

Budgetary accounting measures appropriation and consumption of budget/spending authority or other budgetary resources and facilitates compliance with legal constraints and controls over the use of Federal funds. Under budgetary reporting principles, budgetary resources are consumed at the time of purchase. Assets and liabilities, which do not consume current budgetary resources, are not reported, and only those liabilities for which valid obligations have been established are considered to consume budgetary resources.

For the past 30 years, Congress has enacted no-year appropriations, which are available for obligation by NRC until expended. The Energy and Water Development Appropriations Act, 2004, requires the NRC to recover approximately 92 percent of its new budget authority of $625.6 million by assessing fees less amounts derived from the Nuclear Waste Fund of $32.9 million. The $625.6 million includes recissions of $280 thousand to NRC's appropriation from P.L. 108-199 and $195 thousand to the Nuclear Waste Fund appropriation. The $625.6 million does not include any amounts transferred from the U.S. Agency for International Development.

For FY 2003, NRC recovered approximately 94 percent of its new budget authority of $584.6 million less amounts derived from the Nuclear Waste Funds of $24.7 million.



D. *Basis of Accounting*

Transactions are recorded on an accrual accounting basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Interest on borrowings of the U.S. Treasury is not included as a cost to NRC's programs and is not included in the accompanying financial statements.

E. *Revenues and Other Financing Sources*

The NRC is required to offset its appropriations by the amount of revenues received during the fiscal year by assessing fees. The NRC assesses two types of fees to recover its budget authority: (1) fees assessed under 10 Code of Federal Regulations (CFR) Part 170 for licensing, inspection, and other services under the authority of the Independent Offices Appropriation Act of 1952 to recover the NRC's costs of providing individually identifiable services to specific applicants and licensees; and (2) annual fees assessed for nuclear facilities and materials licensees under 10 CFR Part 171. All fees, with the exception of civil penalties, are exchange revenues in accordance with Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*.

For accounting purposes, appropriations are recognized as financing sources (appropriations used) at the time expenses are accrued. At the end of the fiscal year, appropriations recognized are reduced by the amount of assessed fees collected during the fiscal year to the extent of new budget authority for the year. Collections which exceed the new budget authority are held to offset subsequent years' appropriations. Appropriations expended for property and equipment are recognized as expenses when the asset is consumed in operations (depreciation and amortization).

F. *Fund Balances with Treasury and Cash and Other Monetary Assets*

The NRC's cash receipts and disbursements are processed by the U.S. Treasury. The fund balances with the U.S. Treasury and cash are primarily appropriated funds that are available to pay current liabilities and to finance authorized purchase commitments. Funds with Treasury represent NRC's right to draw on the U.S. Treasury for allowable expenditures. All amounts are available to NRC for current use. Cash balances held outside the U.S. Treasury are not material.

G. *Accounts Receivable*

Accounts receivable consist of amounts owed to the NRC by other Federal agencies and the public. Amounts due from the public are presented net of an allowance for uncollectible accounts. The allowance is based on an analysis of the outstanding balances. Receivables from Federal agencies are expected to be collected; therefore, there is no allowance for uncollectible accounts.

H. Non-Entity Assets

Accounts receivable include non-entity assets of $7,000 and $44,000 at September 30, 2004 and 2003, respectively, and consist of miscellaneous penalties and interest due from the public, which, when collected, must be transferred to the U.S. Treasury.

I. Property and Equipment

Property and equipment consist primarily of typical office furnishings, nuclear reactor simulators, and computer hardware and software. The costs of internal use software include the full cost of salaries and benefits from agency personnel involved in software development. The agency has no real property. The land and buildings in which NRC operates are provided by the General Services Administration (GSA), which charges NRC rent that approximates the commercial rental rates for similar properties.

Property with a cost of $50,000 or more per unit and a useful life of 2 years or more is capitalized at cost and depreciated using the straight-line method over the useful life. Other property items are expensed when purchased. Normal repairs and maintenance are charged to expense as incurred.

J. Accounts Payable

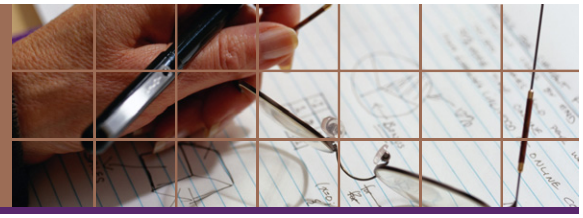
Accounts payable represent vendor invoices for services received by NRC that will be paid at a later date.

K. Liabilities Not Covered by Budgetary Resources

Liabilities represent the amount of monies or other resources that are likely to be paid by NRC as the result of a transaction or event that has already occurred. No liability can be paid by NRC absent an appropriation. Liabilities for which an appropriation has not been enacted and for which there is no certainty that an appropriation will be enacted are classified as Liabilities Not Covered by Budgetary Resources. Also, NRC liabilities arising from sources other than contracts can be abrogated by the Government acting in its sovereign capacity.

Intragovernmental

The U.S. Department of Labor (DOL) paid Federal Employees Compensation Act (FECA) benefits on behalf of NRC which had not been billed or paid by NRC as of September 30, 2004, and 2003, respectively.



Federal Employee Benefits

Federal employee benefits represent the actuarial liability for estimated future FECA disability benefits. The future workers' compensation estimate was generated by DOL from an application of actuarial procedures developed to estimate the liability for FECA, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability was calculated using historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. These projected annual benefit payments were discounted to present value. The interest rate assumptions utilized for discounting benefits were 4.88 percent for FY 2004 and 3.84 percent for FY 2003.

Other

Accrued annual leave represents the amount of annual leave earned by NRC employees but not yet taken.

L. Contingencies

Contingent liabilities are those where the existence or amount of the liability cannot be determined with certainty pending the outcome of future events. The NRC is a party to various administrative proceedings, legal actions, environmental suits, and claims brought by or against it. Based on the advice of legal counsel concerning contingencies, it is the opinion of management that the ultimate resolution of these proceedings, actions, suits, and claims will not materially affect the agency's financial statements.

M. Annual, Sick, and Other Leave

Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave liability account is adjusted to reflect current pay rates. To the extent that current or prior year funding is not available to cover annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as taken.

N. Retirement Plans

NRC employees belong to either the Federal Employees Retirement System (FERS) or the Civil Service Retirement System (CSRS). For FY 2004 and FY 2003, employees belonging to FERS, the NRC withheld 0.8 percent of base pay earnings, in addition to Federal Insurance Contribution Act (FICA) withholdings, and matched the withholdings with a 10.7 percent contribution. The sum is transferred to the Federal Employees Retirement Fund. For employees covered by CSRS, NRC withholds 7 percent of base pay earnings. The NRC matched this withholding with a 7 percent contribution in FY 2004 and FY 2003.

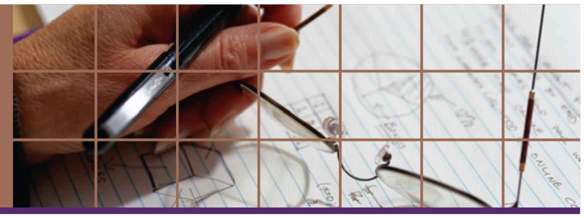
The Thrift Savings Plan (TSP) is a retirement savings and investment plan for employees belonging to either FERS or CSRS. For employees belonging to FERS, NRC automatically contributes 1 percent of base pay to their account and matches contributions up to an additional 4 percent. The maximum percentage of base pay that an employee participating in FERS may contribute is 14 percent in calendar year (CY) 2004, and 13 percent in CY 2003. Employees belonging to CSRS may contribute up to 9 percent of their salary in CY 2004, and 8 percent in CY 2003, but there is no NRC matching of the contribution. The maximum amount that either FERS or CSRS employees may contribute to the plan is $13,000 in the CY 2004 and $12,000 in the CY 2003. The sum of the employees' and NRC's contributions are transferred to the Federal Retirement Thrift Investment Board.

The NRC does not report on its financial statements FERS and CSRS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the U.S. Office of Personnel Management. The portion of the current and estimated future outlays for CSRS not paid by NRC is, in accordance with Statement of Federal Financial Accounting Standards No. 5, Accounting for Liabilities of the Federal Government, included in NRC's financial statements as an imputed financing source.

O. Leases

The total capital lease liability is funded on an annual basis and included in NRC's annual budget. The NRC's capital leases are for personal property consisting of reproduction equipment which is installed at NRC headquarters. During the first quarter FY 2004, one of the capital leases (3 years at 6.59 percent) was completed. In FY 2004, two new capital leases were identified which were for 5 years and the interest rate paid was 4.38 percent for both leases. For FY 2003, the leases were for 3 and 5 years and the interest rate paid was 6.59 percent and 4.38 percent, respectively. The reproduction equipment is depreciated over 5 years using the straight-line method with no salvage value.

Operating leases consist of real property leases with GSA. The leases are for NRC's headquarters and regional offices. The GSA charges NRC lease rates which approximate commercial rates for comparable space.



P. U.S. Department of Energy Charges

Financial transactions between the Department of Energy (DOE) and NRC are fully automated through the U.S. Treasury's Intragovernmental Payment and Collection (IPAC) System. The IPAC System allows DOE to collect amounts due from NRC directly from NRC's account at the U.S. Treasury for goods and/or services rendered. Project manager verification of goods and/or services received is subsequently accomplished through a system-generated voucher approval process. The vouchers are returned to the Office of the Chief Financial Officer documenting that the charges have been accepted.

Q. Pricing Policy

The NRC provides goods and services to the public and other Government entities. In accordance with OMB Circular No. A-25, User Charges, and the Independent Offices Appropriation Act of 1952, NRC assesses fees under 10 CFR Part 170 for licensing and inspection activities to recover the full cost of providing individually identifiable services.

The NRC's policy is to recover the full cost of goods and services provided to other Government entities where: (1) the services performed are not part of its statutory mission and (2) NRC has not received appropriations for those services. Fees for reimbursable work are assessed at the 10 CFR Part 170 rate with minor exceptions for programs that are nominal activities of the NRC.

R. Net Position

The NRC's net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent appropriated spending authority that is unobligated and has not been withdrawn by Treasury, and obligations that have not been paid. Cumulative results of operations represent the excess of financing sources over expenses since inception.

S. Use of Management Estimates

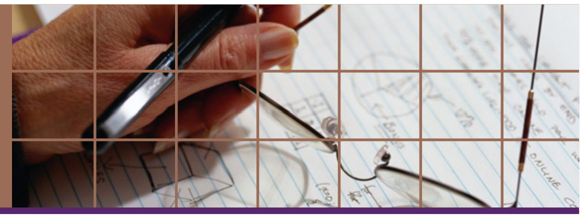
The preparation of the accompanying financial statements in accordance with generally accepted accounting principles requires management to make certain estimates and assumptions that directly affect the results of reported assets, liabilities, revenues, and expenses. Actual results could differ from these estimates.

NOTE 2. FUND BALANCES WITH TREASURY

(In thousands) **Fund Balances**	**2004**	Restated 2003
Appropriated funds	**$ 193,547**	$ 184,487
Allocation transfers	**3,839**	5,183
Other fund types	**2,891**	3,750
Total	**$ 200,277**	$ 193,420
Status of Fund Balance with Treasury		
Unobligated Balance		
Available		
Appropriated funds	**$ 36,329**	$ 40,572
Allocation transfers	**1,857**	2,948
Unavailable	**3,046**	4,063
Obligated balance not yet disbursed	**159,045**	145,837
Total	**$ 200,277**	$ 193,420

NOTE 3. ACCOUNTS RECEIVABLE

(In thousands)	**2004**	Restated 2003
Intragovernmental		
Receivables and reimbursements	**$ 3,357**	$ 2,667
Receivables with the Public		
Materials and facilities fees - billed	**$ 3,060**	$ 4,657
Materials and facilities fees - unbilled	**49,684**	48,605
Other (Penalties and Interest)	**37**	110
Total Accounts Receivable	**52,781**	53,372
Less: Allowance for uncollectible accounts	**(2,133)**	(2,811)
Accounts Receivable, Net	**$ 50,648**	$ 50,561



NOTE 4. PROPERTY AND EQUIPMENT, NET

(In thousands)

Fixed Assets Class	Service Years	Acquisition Value	Accumulated Depreciation and Amortization	2004 Net Book Value	Restated 2003 Net Book Value
Equipment	5-8	$ 15,691	$ (13,867)	**$ 1,824**	$ 2,345
ADP software	5	40,628	(30,340)	**10,288**	15,310
ADP software under development	-	3,897	-	**3,897**	2,318
Leasehold improvements	20	21,856	(11,240)	**10,617**	10,153
Leasehold improvements in progress		57	-	**57**	79
		$ 82,129	$ (55,447)	**$ 26,683**	$ 30,205

NOTE 5. OTHER LIABILITIES

(In thousands)

	2004	Restated 2003
Intragovernmental		
Liability to offset net accounts receivable for fees assessed	**$ 53,704**	$ 52,490
Liability from fees collected which will offset current year's appropriations	**2,857**	3,590
Liability to offset miscellaneous accounts receivable	**7**	42
Liability for advances from other agencies	**1,778**	1,222
Accrued workers' compensation	**1,655**	1,646
Accrued unemployment compensation	**24**	29
Employee benefit contributions	**1,543**	1,063
Total Intragovernmental Other Liabilities	**$ 61,568**	$ 60,082

The liability to offset the net accounts receivable for fees assessed represents amounts which, when collected, will be transferred to the U.S. Treasury to offset NRC's appropriations in the year collected.

(In thousands)	2004	2003
Accrued annual leave	**$ 32,205**	$ 30,035
Accrued salaries	**13,001**	8,137
Contract holdbacks, advances, and other	**3,111**	3,532
Total Other Liabilities	**$ 48,317**	$ 41,704

Other liabilities, except accrued annual leave, contract holdbacks, and advances from others, are current.

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

(In thousands)	**2004**	Restated 2003
Intragovernmental		
FECA paid by DOL	**$ 1,655**	$ 1,646
Accrued unemployment compensation	**24**	29
Federal Employee Benefits		
Future FECA	**8,114**	9,073
Other		
Accrued annual leave	**32,205**	30,035
Total Liabilities not Covered by Budgetary Resources	**$ 41,998**	$ 40,783

NOTE 7. LEASES

(In thousands)

Future Lease Payments Due:

	Fiscal Year	Capital	Operating	**2004**	Restated 2003
	2004	$ -	$ -	**$ -**	$ 20,657
	2005	157	22,823	**22,980**	20,529
	2006	164	22,054	**22,218**	19,724
	2007	128	22,143	**22,271**	19,731
	2008	-	21,013	**21,013**	18,473
	2009 and thereafter	-	107,031	**107,031**	93,127
	Total	449	195,064	**195,513**	192,241
Add: imputed interest		28	-	**28**	52
Total Future Lease Payments		$ 477	$ 195,064	**$ 195,541**	$192,293

NOTE 8. CUMULATIVE RESULTS OF OPERATIONS

(In thousands)	**2004**	Restated 2003
Future funding requirements	**$ (41,998)**	$ (40,783)
Investment in property and equipment, net	**26,683**	30,205
Contributions from foreign cooperative research agreements	**2,739**	2,481
Other	**34**	8
Cumulative Results of Operations	**$ (12,542)**	$ (8,089)

Future funding requirements represent the amount of future funding needed to pay the accrued unfunded expenses as of September 30, 2004 and 2003. These accruals are not funded from current or prior-year appropriations and assessments, but rather should be funded from future appropriations and assessments. Accordingly, future funding requirements have been recognized for the expenses that will be paid from future appropriations.

NOTE 9. EXCHANGE REVENUES

(In thousands)	**2004**	Restated 2003
Fees for licensing, inspection, and other services	**$ 546,515**	$ 534,565
Revenue from reimbursable work	**5,652**	5,916
Total Exchange Revenues	**$ 552,167**	$ 540,481

NOTE 10. BUDGET FUNCTIONAL CLASSIFICATION

(In thousands)			**2004**	Restated 2003
Functional Classification	**Gross Cost**	**Earned Revenue**	**Net Cost**	Net Cost
276- Energy Information, Policy, & Regulation	$ 659,389	$ 552,167	**$ 107,222**	$ 56,391
150- AID International Affairs	3,246	-	**3,246**	4,269
Total	$ 662,635	$ 552,167	**$ 110,468**	$ 60,660
Intragovernmental				
276 - Energy Information, Policy, & Regulation	$ 194,079	$ 33,914	**$ 160,165**	$ 136,027
150 - AID International Affairs	3,246	-	**3,246**	4,269
Total	$ 197,325	$ 33,914	**$ 163,411**	$ 140,296

NOTE 11. FINANCING SOURCES OTHER THAN EXCHANGE REVENUE

(In thousands)

Appropriated Funds Used

Collections were used to reduce the fiscal year's appropriations recognized:

	2004	Restated 2003
Funds consumed	**$ 627,401**	$ 564,893
Less: collection from fees assessed	**(545,302)**	(526,273)
Appropriated funds used	**$ 82,099**	$ 38,620

Funds consumed includes $43.8 million and $39.8 million through September 30, 2004 and 2003, respectively, of available funds from prior years.

Non-Exchange Revenue

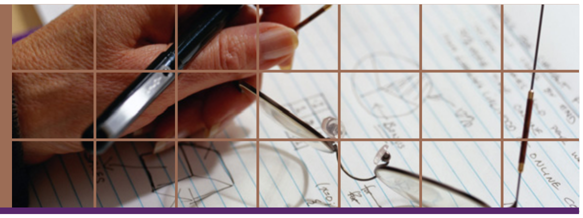
	2004	2003
Civil penalties	**$ 622**	$ 353
Miscellaneous receipts	**103**	271
Total Non-Exchange Revenue	**$ 725**	$ 624

Imputed Financing

	2004	2003
Civil Service Retirement System	**$ 13,073**	$ 11,588
Federal Employee Health Benefit	**11,924**	9,832
Federal Employee Group Life Insurance	**57**	53
Judgements Awards	**75**	505
Total Imputed Financing	**$ 25,129**	$ 21,978

Transfers In/Out

	2004	2003
Transfers out to Treasury		
License Fees	**$ 545,302**	$ 526,273
Non-exchange revenue	**725**	624
Total Transfers-Out to Treasury	**$ 546,027**	$ 526,897



NOTE 12. TOTAL OBLIGATIONS INCURRED

(In thousands)	**2004**	Restated 2003
Direct Obligations		
Category A	**$ 606,764**	$ 565,784
Exempt from Apportionment	**32,558**	25,194
Total Direct Obligations	**639,322**	590,978
Reimbursable Obligations	**5,953**	6,050
Total Obligations Incurred	**$ 645,275**	$ 597,028

Obligations exempt from apportionment are the result of funds derived from the Nuclear Waste Fund. Category A Obligations consist of NRC appropriations only.

NOTE 13. RESTATEMENT OF FY 2003 FINANCIAL STATEMENTS

NRC restated the FY 2003 financial statements to reflect approximately $3 million in fees that had not been previously billed due to deficiencies in the fee billings system and to record two previously unrecorded capital leases for equipment acquired in FY 2002. The ending obligated balance in the Statement of Budgetary Resources was also restated to reclassify unfilled customer orders of $4.7 million.

As a result of the restatement, assets, liabilities, net position, and net cost of operations were changed as follows:

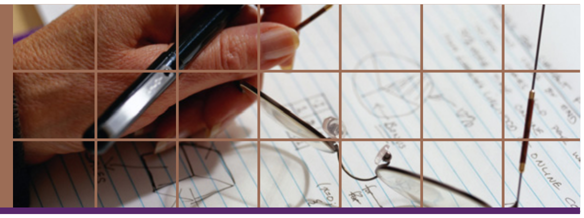
Account Classes	**As Previously Reported**	**As Restated**
Assets	$ 276,244	$ 279,825
Liabilities	134,599	138,195
Net Position	141,645	141,630
Net Cost of Operations	63,646	60,660

REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF INTRAGOVERNMENTAL ASSETS AND LIABILITIES

(Dollars in Thousands) As of September 30,	**2004**	2003
Intragovernmental Assets		
Fund Balance with Treasury		
Department of the Treasury	**$ 200,277**	$ 193,420
Accounts Receivable		
Tennessee Valley Authority	**2,952**	1,844
Department of Energy	**171**	600
Other Agencies	**234**	223
Total Accounts Receivable	**3,357**	$ 2,667
Other Assets		
General Services Administration	**-**	487
Department of Commerce	**778**	227
Department of Interior	**588**	664
Department of the Navy	**634**	1,495
Department of Labor	**42**	42
Other Agencies	**253**	18
Total Other Assets	**2,295**	2,933
Total Intragovernmental Assets	**$ 205,929**	$ 199,020

(Dollars in Thousands) As of September 30,	**2004**	2003
Intragovernmental Liabilities		
Accounts Payable		
General Services Administration	**$ 1,223**	$ 953
Department of Energy	**6,330**	5,851
Other Agencies	**1,011**	595
Total Accounts Payable	**8,564**	7,399
Other Liabilities		
Department of the Treasury - General Fund	**56,561**	56,080
Department of Labor	**1,679**	1,675
Office of Personnel Management	**1,543**	1,063
Other Agencies	**1,785**	1,264
Total Other Liabilities	**61,568**	60,082
Total Intragovernmental Liabilities	**$ 70,132**	$ 67,481



SCHEDULE OF BUDGETARY RESOURCES

(Dollars in Thousands)
For the year ended September 30, 2004

	X0200	X0300	Total
Budgetary Resources			
Budget authority			
Appropriations received	$ 585,700	$ 7,300	$ 593,000
Net transfers	32,905	-	32,905
Unobligated balances			
Beginning of period	39,351	1,221	40,572
Spending authority from offsetting collections			
Reimbursements earned	5,491	-	5,491
Change in unfilled customer orders	1,298	-	1,298
Anticipated reimbursement and other income	-	-	0
Total Spending Authority from Offsetting Collections	6,789	0	6,789
Recoveries of prior year obligations	8,529	89	8,618
Permanently not available	(277)	(3)	(280)
Total Budgetary Resources	$ 672,997	$ 8,607	$ 681,604
Status of Budgetary Resources:			
Obligations incurred			
Direct	$ 632,012	$ 7,310	$ 639,322
Reimbursable	5,953	-	5,953
Unobligated balance			
Apportioned	33,985	1,297	35,282
Exempt from apportionment	1,047	-	1,047
Unobligated balance not available	-	-	0
Total Status of Budgetary Resources	$ 672,997	$ 8,607	$ 681,604
Relationship of Obligations to Outlays:			
Obligated balance, net, beginning of period	$ 142,862	$ 1,072	$ 143,934
Obligated balance, net, end of period:			
Accounts receivable	(275)	-	(275)
Unfilled customer orders from Federal sources	(3,882)	-	(3,882)
Undelivered orders	116,254	896	117,150
Accounts payable	43,822	403	44,225
Obligated balance, net , end of period	$ 155,919	$ 1,299	$ 157,218
Outlays:			
Disbursements	$ 616,137	$ 6,994	$ 623,131
Collections	(6,545)	(1)	(6,546)
Subtotal	609,592	6,993	616,585
Less: Offsetting receipts	(538,589)	(6,713)	(545,302)
Net Outlays	$ 71,003	$ 280	$ 71,283

Auditors' Reports and Financial Statements