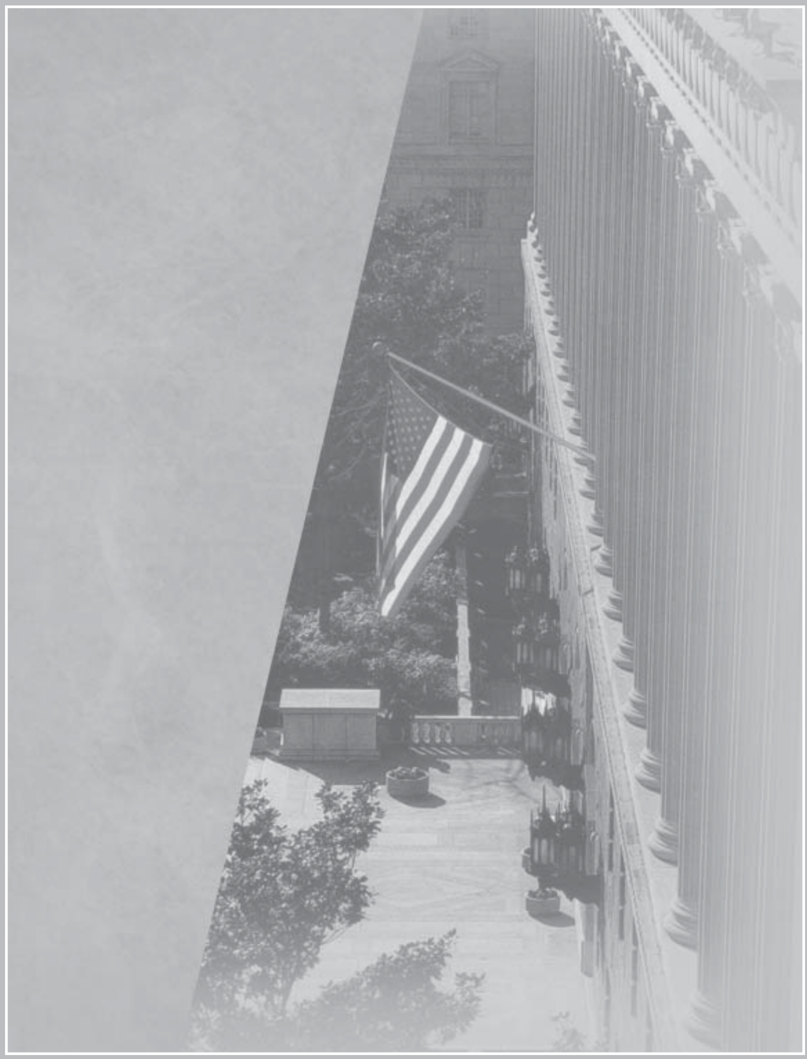
Independent Auditors' Report

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UNITED STATES DEPARTMENT OF COMMERCE
The Inspector General
Washington, D.C. 20230

November 10, 2005

MEMORANDUM FOR: Carlos M. Gutierrez
Secretary of Commerce

FROM: Johnnie E. Frazier Johnnie Frazier

SUBJECT: *Department of Commerce's FY 2005 Consolidated Financial Statements*, Audit Report No. FSD-17433-6-0001

I am pleased to provide you with the attached audit report, which presents an unqualified opinion on the Department of Commerce's FY2005 consolidated financial statements. The audit results indicate that the Department has established an internal control structure that facilitates the preparation of reliable financial and performance information. We commend the Department for the noteworthy accomplishment of once again attaining an unqualified opinion—the seventh consecutive year, and for meeting the fiscal year 2005 accelerated reporting deadline.

My office contracted with the independent public accounting firm of KPMG LLP (KPMG) to perform the audit of the Department's financial statements as of and for the year ended September 30, 2005. The contract required that the audit be done in accordance with U.S. generally accepted government auditing standards and OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements.*

In its audit of the Department, KPMG found that:

- the financial statements were fairly presented, in all material respects and in conformity with U.S. generally accepted accounting principles;
- there were two reportable conditions related to weaknesses in controls over the Department's financial management systems and National Institute of Standards and Technology's construction-in-progress account monitoring (but not considered material weaknesses in internal control as defined on page 3 of the audit report);
- there were no instances in which the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996; and
- there was one instance in which the Department did not comply with other laws and regulations tested—the Anti-Deficiency Act.

Although continued strengthening of internal controls is necessary, we are pleased that in 2005 the Department made improvements in general information technology controls and eliminated a finding of noncompliance with laws and regulations (a repeat condition since 1997). During fiscal year 2005, the National Oceanic and Atmospheric Administration achieved compliance

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with OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, by fully funding all of its capital leases. These successes are due to the Department's continued commitment to sound financial management and reliable financial/performance information and the important role and substantial efforts of the Department's financial managers and staff to improve internal controls and eliminate specific deficiencies identified by KPMG and our office in prior audits.

My office defined the audit's scope and oversaw its performance and delivery. We reviewed KPMG's report and related documentation, and made inquiries of its representatives. Our review disclosed no instances where KPMG did not comply, in all material respects, with U.S. generally accepted government auditing standards. However, our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the Department's consolidated financial statements, conclusions about the effectiveness of internal control, or conclusions on compliance with laws and regulations. KPMG is responsible for the attached audit report dated November 8, 2005, and the conclusions expressed in the report.

In accordance with Department Administrative Order (DAO) 213-5, we ask that the Department's Chief Financial Officer and Assistant Secretary for Administration provide for our review and concurrence an audit action plan that addresses all of the recommendations contained in this report within 60 days of the date of this memorandum.

If you wish to discuss the contents of this report, please call me on (202) 482-4661, or Edward Blansitt, Deputy Inspector General, on (202) 482-3516. We appreciate the cooperation and courtesies the Department extended to KPMG and my staff during the audit.

Attachment

cc: Otto J. Wolff
Chief Financial Officer and Assistant Secretary for Administration

Tom Pyke
Chief Information Officer

Thomas Klausing
Acting Chief Financial Officer, NIST

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Office of Inspector General, U.S. Department of Commerce and
Secretary, U.S. Department of Commerce:

We have audited the accompanying consolidated balance sheets of the U. S. Department of Commerce (Department) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources (hereinafter referred to as consolidated financial statements), for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered the Department's internal control over financial reporting and tested the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that the Department's consolidated financial statements as of and for the years ended September 30, 2005 and 2004, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the identification of two reportable conditions, related to weaknesses in the Department's general information technology controls and the National Institute of Standards and Technology's (NIST) construction-in-progress account monitoring controls. However, we do not consider these reportable conditions to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed one instance of noncompliance or other matters that are required to be reported under *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 following sections discuss our opinion on the Department's consolidated financial statements, our consideration of the Department's internal control over financial reporting, our tests of the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements, and management's and our responsibilities.

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OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the U.S. Department of Commerce as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, financing, and the related combined statements of budgetary resources, for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2005 and 2004, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The information in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Circular A-136, *Financial Reporting Requirements*, Part A, *Form and Content of the Performance and Accountability Report*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The September 30, 2005 consolidating balance sheet is presented for purposes of additional analysis of the consolidated balance sheet rather than to present the financial position of the Department's bureaus individually. The September 30, 2005 consolidating balance sheet has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, based on our audits, is fairly stated in all material respects in relation to the September 30, 2005 consolidated balance sheet taken as a whole. The information in the FY 2005 Performance Section, Appendices, and the information on pages IV through VIII, are presented for purposes of additional analysis and are not required as part of the consolidated financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record,

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process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the consolidated 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.

In our fiscal year 2005 audit, we noted certain matters, summarized below and in more detail in Exhibit I, involving internal control over financial reporting and its operation that we consider to be reportable conditions. However, these reportable conditions are not believed to be material weaknesses.

- **General information technology controls**. We found that although the Department has taken corrective actions to address certain information technology (IT) control weaknesses, general IT weaknesses still exist. Despite the positive efforts made by the Department, the Department needs to make continued improvement in its IT general control environment to fully ensure that financial data being processed on the Department's systems has integrity, is confidentially maintained, and is available when needed.

- **Accounting for NIST construction-in-progress**. Prior to March 31, 2005, NIST did not have a policy requiring a periodic reconciliation of the construction-in-progress (CIP) account balance, by project, to active construction project files maintained by the NIST facilities management personnel in Gaithersburg, Maryland and Boulder, Colorado. NIST also did not have a procedure to annually validate the status of project balances in the CIP account. The lack of sufficient monitoring controls resulted in an overstatement of CIP from costs incurred between 1998 and 2004 that should have been expensed or transferred to completed property projects.

* * * * *

A summary of the status of the Department's prior year reportable condition is included as Exhibit II.

We also noted certain additional matters that we reported to the management of the Department in two separate letters addressing information technology and other matters, respectively.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and is described below.

- **Anti-Deficiency Act.** As reported in the prior year audit, we were informed by the National Oceanic and Atmospheric Administration (NOAA) that during fiscal year 2004, it identified two reimbursable agreements, one signed in fiscal year 2000 and the other in fiscal year 2001, between NOAA and nonprofit entities that contained indemnification clauses. As of November 9, 2004, the date of our fiscal year 2004 Independent Auditors' Report, the two agreements were amended, eliminating future Anti-Deficiency Act (ADA) concerns and the Department's Office of General Counsel (OGC) was reviewing this matter to determine whether an ADA violation occurred. Subsequently, OGC determined that the indemnification clauses were *prima facie* violations of the ADA because those clauses constituted open-ended obligations of the Government, even though no liability claims were filed under the agreements. The Department reported these violations to the President and Congress on December 20, 2004, as required by United States Code (USC) Title 31 Section 1517 and 1351. The OGC also reported these violations to the Comptroller General of the United States on March 14, 2005.

  In a separate OGC review, OGC identified a license that also contained an indemnification clause. NOAA reviewed other real property arrangements (such as leases and licenses), to ensure that those agreements did not contain indemnification clauses. NOAA found that 80 of 2,130 real property agreements, with the earliest signed in 1923, included indemnification clauses or provisions involving an indeterminate liability, or both. The OGC determined that these clauses or provisions also were *prima facie* violations of the ADA. Each individual who signed those agreements and who is still a NOAA employee has been given administrative discipline under the Department of Commerce Table of Offenses and Penalties. The Department reported these violations to OMB for their review and forwarding to the President. OMB has not yet forwarded the report to the President. On the day it does so, the Department will simultaneously send letters to Congress and the Comptroller General of the United States as required by 31 USC Section 1517(b), as amended.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

FFMIA. The results of our tests of FFMIA disclosed no instances in which the Department's financial management systems did not substantially comply with the three requirements discussed in the Responsibilities section of this report.

Additional Concern. The OGC informed us that during fiscal year 2005, the Economic and Statistics Administration (ESA) identified a one-year agreement between ESA and a foreign government that contained an indemnification clause. As a result of this

discovery, ESA conducted an investigation and located six previously executed one-year agreements for subscription services with the same party containing the same indemnification clause. The agreements have been provided to OGC to determine whether an ADA violation occurred, but a conclusion has not yet been reached. ESA has confirmed that no claims have been made against ESA or the Department based on these agreements. Since OGC's review is not complete, the outcome of this matter, and any resulting ramifications, is not presently known.

RESPONSIBILITIES

Management's Responsibilities. The *Government Management Reform Act of 1994*, *Accountability of Tax Dollars Act,* and *Government Corporation Control Act* require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, the Department prepares and submits consolidated financial statements in accordance with Part A of OMB Circular A-136.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;

- Preparing the Management Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information;

- Establishing and maintaining internal controls over financial reporting; and

- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2005 and 2004 consolidated financial statements of the Department 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*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not

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for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2005 audit, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on the Department's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, in our fiscal year 2005 audit, we considered the Department's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of the Department's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over the Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, in our fiscal year 2005 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management Discussion and Analysis and Performance sections, 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 reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the Department's fiscal year 2005 consolidated financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws, regulations,

contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the Department. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the Department's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

DISTRIBUTION

This report is intended solely for the information and use of the Department's management, the Department's Office of Inspector General, OMB, the Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2005

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Reportable Conditions

Financial Management Systems Need Improvement ***(Repeat Condition Since 1998)***

For many years, the U.S. Department of Commerce (Department) Office of Inspector General (OIG), U.S. Government Accountability Office (GAO), and departmental self-assessments have identified weaknesses in the Department's information technology (IT) and financial systems controls. Our fiscal year 2005 assessment of the Department's general IT and financial systems controls, performed in support of the fiscal year 2005 consolidated financial statement audit, found that although the Department needs to make further progress with its general IT control environment, progress has been made in addressing many prior weaknesses. For example, during FY 2005 Commerce took several positive steps with its IT control processes, not only to improve controls and processes, but also to help address previously reported IT control weaknesses, including an IT security material weakness reported under the *Federal Managers' Financial Integrity Act* (FMFIA).

As in FY 2004, Commerce continued to focus on improving the Department's information security certification and accreditation program, which is a key information security management and technical control process. Additionally, in June 2005, the Department successfully met its goal of publishing a major revision to the *Department of Commerce IT Security Program Policy and Minimum Implementation Standards*. The guidance defines updated DOC mandatory minimally acceptable standards for the implementation of effective IT security programs at all bureaus and operating units. The newly published version incorporates, by reference, the most current Public Laws, Federal requirements, and Departmental policies and procedures affecting security of Federal information systems. It also includes recommended management practices of the Federal government and private industry.

Despite these improvements, we continued to identify weaknesses in general IT controls that we consider to be a reportable condition as defined by the American Institute of Certified Public Accountants. As part of the Department's fiscal year 2005 FMFIA evaluation, the Department determined (and the OIG also confirmed) that a material weakness, related to IT information security, continues to exist.

Effective general IT controls add assurance that data used to prepare and report financial information and statements is complete, reliable, and has integrity. Our fiscal year 2005 IT assessment was focused on the general IT controls over the Department's major financial management systems and supporting network infrastructure, using GAO's *Federal Information System Controls Audit Manual* (FISCAM) as a guide. The six FISCAM general IT control review elements, and our related findings, are as follows:

- **Entity-wide security program.** An entity-wide security program for security planning and management is the foundation of an organization's information security control structure. The program should provide a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of computer-related security controls.

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Reportable Conditions, Continued

Although the Department has made improvements in this area, our audit identified that entity-wide security can still be improved at several bureaus, primarily in the areas of: (1) updating system security plans, (2) execution of non-disclosure agreements by contractors, and (3) security awareness and specialized security training. We also noted that during the year one bureau had not re-certified a system after a major upgrade.

Office of Management and Budget (OMB) Circular A-130, *Management of Federal Information Resources*, provides key guidance for establishing and maintaining an entity-wide information security program. Collectively, the identified entity-wide security planning and management issues, coupled with the access control issues described below, reduce the overall effectiveness of the entity-wide security programs for the individual bureaus and operating units, and the overall Department. The *Department of Commerce IT Security Program Policy and Minimum Implementation Standards*, reiterates OMB Circular A-130 guidance, and implements key elements of such guidance as Department-wide policy.

- **Security access controls.** In close concert with an organization's entity-wide information security program, access controls for general support systems and financial systems should provide reasonable assurance that computer resources such as data files, application programs, and computer-related facilities and equipment are protected against unauthorized modification, disclosure, loss, or impairment. Access controls are facilitated by an organization's entity-wide security program. Such controls include physical controls and logical controls.

  The objectives of limiting access are to ensure that users have only the access needed to perform their duties; that access to very sensitive resources, such as security software programs, is limited to very few individuals; and that employees are restricted from performing incompatible functions or functions beyond their responsibility. This is reiterated by Federal guidelines. For example, OMB Circular A-130 and supporting National Institute of Standards and Technology (NIST) security publications provide guidance related to the maintenance of technical access controls. In addition, the *Department of Commerce IT Security Program Policy and Minimum Implementation Standards* contain many requirements for operating Department IT devices in a secure manner.

  During fiscal year 2005, we noted that access controls should be improved at all Department bureaus, primarily in the areas of improved: (1) management of user accounts, (2) logical controls for network and remote access, (3) requirements for obtaining signed user Rules of Behavior, and (4) technical controls for system devices to protect against vulnerabilities associated with malicious threats and attacks. We recognize that the Department and its bureaus have some compensating controls in place to help reduce the risk of the identified vulnerabilities, and we have considered

such compensating controls as part of our overall consolidated financial statement audit.

- **Application software development and change control**. The primary focus of application software development and change control is on controlling the changes that are made to software systems in operation. Establishing controls over the modification of application software programs ensures that only authorized programs and authorized modifications are implemented. This is accomplished by instituting policies, procedures, and techniques to determine that all programs and program modifications are properly authorized, tested, and approved, and that access to and distribution of programs is carefully controlled. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or turned off, or that processing irregularities or malicious code could be introduced into the IT environment.

  During fiscal year 2005, we noted that application software development and change controls should be improved at three bureaus, primarily in the areas of better: (1) processes for the removal of unauthorized personal and public software, (2) monitoring of access to the production environment, and (3) tracking of access to software libraries.

- **System software.** System software is a set of programs designed to operate and control the processing activities of computer equipment. System software helps control the input, processing, output, and data storage associated with all of the applications that run on a system. Controls over access to and modification of system software are essential in providing reasonable assurance that operating system-based security controls are not compromised and that the system will not be impaired.

  During fiscal year 2005, we noted that system software controls should be improved at two bureaus, primarily in the areas of: (1) restricting and monitoring the use of system software, and (2) improving patch management processes.

- **Segregation of duties.** Work responsibilities should be segregated so that an individual does not control more than one critical function within a process. Inadequately segregated duties increase the risk that erroneous or fraudulent transactions could be processed, improper program changes could be implemented, and computer resources could be damaged or destroyed. Key areas of concern for segregation of duties involves duties among major operating and programming activities, including duties performed by users, application programmers, and data center staff. Policies outlining individual responsibilities should be documented, communicated, and enforced. The prevention and/or detection of unauthorized or erroneous actions by personnel require effective supervision and review by management, as well as formal operating procedures.

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Reportable Conditions, Continued

During fiscal year 2005, we noted that controls over segregation of duties should be improved at two bureaus, primarily related to segregating key IT functions and better documentation of IT-related position descriptions.

- **Service continuity**. Losing the capability to process, retrieve, and protect information maintained electronically can significantly affect an agency's ability to accomplish its mission. For this reason, an agency should have: (1) procedures in place to protect information resources and minimize the risk of unplanned interruptions, and (2) a plan to recover critical operations should interruptions occur.

  During fiscal year 2005, we noted that service continuity controls should be improved at several Department bureaus, primarily in the areas of: (1) testing disaster recovery and continuity plans, (2) procuring alternate processing sites, (3) including key elements, such as emergency processing priorities, in documented plans, and (4) providing for the regular maintenance and testing of data center environmental controls. We also noted that one bureau had not conducted a business impact analysis as a part of their contingency planning activities.

Recommendations

Specific recommendations are included in a separate limited distribution IT general controls report, issued as part of the fiscal year 2005 consolidated financial statement audit. The Department should monitor bureau actions to ensure effective implementation of our recommendations.

Management's Response

Management agreed with our findings, conclusions, and recommendations related to improving the Department's financial management systems controls. The Department is in the process of finalizing corrective action plans to address the recommendations presented in the separate limited distribution IT general controls report.

Accounting for NIST Construction-In-Progress Needs Improvement

During our audit, the NIST Finance Division (NIST Finance) informed us that its Construction-in-Process (CIP) account did not reconcile to the dollar amount of active CIP projects. NIST determined that its CIP account was overstated by approximately $127 million, related to (1) costs incurred on fiscal year 2004 and prior projects that had since been completed and not transferred to a completed property account, and (2) costs recorded in CIP that were not capitalizable. A detailed analysis of this issue, performed by NIST and its consultants, was hindered because NIST did not maintain documentation to support costs incurred in the CIP account prior to fiscal year 1999. NIST ultimately determined that $68 million should be transferred to completed projects with the associated $6 million of accumulated depreciation added to the general ledger and $59

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Reportable Conditions, Continued

million should be expensed. The expense adjustment relates to over eight years of costs incurred associated with the Construction of Research Facilities (CRF) appropriation that were recorded in CIP, even though the CRF appropriation includes funding for non-capitalizable items (such as routine repairs and maintenance expenditures for existing facilities). Adjustments were made to NIST's CIP account in FY 2005 to correct the Department's consolidated financial statements for these misstatements.

The CIP accounting issues occurred because NIST did not have sufficient controls in place to segregate capitalizable versus non-capitalizable costs. Prior to March 31, 2005, NIST did not have a policy requiring a periodic reconciliation of the CIP account balance, by project, to active construction project files maintained by the NIST facilities management personnel in Gaithersburg, Maryland and Boulder, Colorado. NIST also did not have a procedure to annually validate the status of project balances in the CIP account.

<u>Recommendations</u>

We recommend that the NIST Chief Financial Officer (CFO) establish and enforce routine controls to ensure that completed construction projects are removed timely from CIP and only capitalizable costs are added to NIST's CIP balance. Specifically:

- A routine process should be established that requires communication between NIST Finance and NIST facilities management personnel in Gaithersburg, Maryland and Boulder, Colorado regarding the status of active construction projects to ensure that completed projects are transferred from CIP into completed asset accounts, timely.

- The NIST CFO and Chief Facilities Management Officer should coordinate efforts to ensure that NIST Finance is performing timely quarterly reconciliations of CIP cost reports to ensure that all costs in the CIP account are capitalizable and relate to active construction projects. Additionally, they should also coordinate efforts to ensure that NIST facilities management personnel in Gaithersburg, Maryland and Boulder, Colorado is maintaining complete and current project files and is communicating timely capitalization information to NIST Finance.

- NIST Finance should finalize and implement policies and procedures relating to accounting and reporting of CIP costs. These policies and procedures should incorporate all aspects of accounting for and managing CIP costs, including reviewing appropriation and budget language, monitoring and validating project activities, performing timely quarterly reconciliations, and performing proper capitalization.

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Reportable Conditions, Continued

Management's Response

Management agreed with our findings, conclusions, and recommendations related to improving NIST's accounting for CIP. The Department is in the process of finalizing corrective action plans to address the above recommendations.

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Exhibit II – Status of Prior Year Reportable Condition

Reported Issue	Prior Year Recommendation	Fiscal Year 2005 Status
Financial Management Systems Need Improvement		
Weaknesses in general controls were identified in all six FISCAM review areas.	The Department should monitor bureau actions to ensure effective implementation of our recommendations.	Reportable Condition (see comments in Exhibit I).