

National Aeronautics and
Space Administration
Headquarters
Washington, DC 20546-0001



JAN 30 2003

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TO: A/Administrator
B/Acting Chief Financial Officer

FROM: W/Inspector General

SUBJECT: Audit of the National Aeronautics and Space Administration's
Fiscal Year 2002 Financial Statements

Under the Chief Financial Officers Act of 1990, I am charged with the responsibility for ensuring that NASA's financial statements are audited in accordance with generally accepted government auditing standards. The Office of Inspector General engaged the independent certified public accounting firm PricewaterhouseCoopers LLP (PwC) to audit NASA's financial statements. The Defense Contract Audit Agency performed supporting work related to contractor-held, NASA-owned materials and property, plant and equipment.

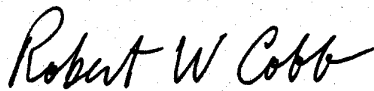
The enclosed *Report of Independent Accountants* provides PwC's unqualified opinion on NASA's financial statements for the fiscal year ended September 30, 2002. An unqualified opinion states that the financial statements are fairly presented in all material respects and in conformity with generally accepted accounting principles.

The enclosed *Report of Independent Accountants on Internal Control* identifies two material weaknesses related to NASA's internal controls over (1) materials and property, plant and equipment, particularly that held by contractors and (2) its processes for preparing financial statements and the Performance and Accountability Report. PwC also identifies six reportable conditions in general controls over NASA's information technology architecture that processes financial applications.

In order to address identified weaknesses in the controls over materials and property, plant and equipment, PwC recommends that NASA create a senior management team as soon as possible comprised of finance, program management, legal, procurement and other personnel. In this regard, PwC recommends that NASA develop a detailed corrective action plan that addresses recommendations from this year's audit as well as those that remain open from last year's audit. PwC also recommends that NASA formalize policies and procedures and ensure that they are implemented and consistently and correctly applied within the Agency and at its contractors. Correcting the control weaknesses, particularly those concerning contractor-held property, will be a significant challenge for NASA, and we strongly endorse PwC's recommendations.

In the enclosed *Report of Independent Accountants on Compliance with Laws and Regulations*, PwC explains that due to the material weaknesses and reportable conditions identified in the internal control report, NASA's financial management system is not in compliance with the requirements of the Federal Financial Management Improvement Act. The recommendations contained in the internal control report are intended to address this issue.

In fulfilling our responsibilities under the Chief Financial Officers Act, we reviewed PwC's reports and selected working papers. Our quality control review is ongoing, but to date we have not identified any instances where PwC did not comply, in all material respects, with generally accepted government auditing standards.



Robert W. Cobb

3 Enclosures

Report of Independent Accountants

To the Inspector General of the
National Aeronautics and Space Administration:

In our opinion, the accompanying Consolidated Balance Sheet and the related Consolidated Statements of Net Cost and Changes in Net Position, Combined Statement of Budgetary Resources and Consolidated Statement of Financing present fairly, in all material respects, the financial position of the National Aeronautics and Space Administration (NASA) at September 30, 2002, and its net cost, changes in net position, budgetary resources and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of NASA's management; our responsibility is to express an opinion on these financial statements based upon our audit. We conducted our audit of these statements 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 Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit 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 audit provides a reasonable basis for our opinion.

The management's discussion and analysis, required supplementary information, and required supplementary stewardship information are not required parts of the basic financial statements but are supplementary information required by the Federal Accounting Standards Advisory Board (FASAB) and OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. 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.

We were previously engaged to audit the accompanying financial statements as of and for the year ended September 30, 2001.

NASA did not provide us with information sufficient to support the amounts reported as obligations, expenses, property, plant, and equipment, and materials in the consolidated

financial statements as of and for the year ended September 30, 2001. Accordingly, we were not able to satisfy ourselves as to the amounts recorded in these accounts.

As discussed in Note 1 to the financial statements, FASAB Statement No. 21, *Reporting of Errors and Changes in Accounting Principles*, requires that errors discovered in previously issued financial statements be corrected by restating the affected period. If the error occurred prior to the earliest period presented, the cumulative effect should be reported as a prior period adjustment. NASA detected certain errors during fiscal year (FY) 2002 that occurred in prior years and recorded those errors as if they had occurred in FY 2001. NASA did not determine what portion of those errors related to each respective prior year and should have been recorded as prior period adjustments, nor did they provide us with information needed to support the accuracy and the classification of the amounts. Accordingly, we were not able to satisfy ourselves as to the amounts of the errors that related to FY 2001 and those that related to years prior to FY 2001.

Because of the matters discussed in the fourth and fifth paragraphs of this report, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the Consolidated Balance Sheet of NASA at September 30, 2001, and the Consolidated Statement of Net Cost for the year then ended.

In accordance with *Government Auditing Standards*, we have also issued a report dated January 24, 2003, on our consideration of NASA's internal control over financial reporting and a report dated January 24, 2003, on its compliance with laws and regulations. These reports, which disclose material weaknesses and other reportable conditions in internal control and non-compliance with the Federal Financial Management Improvement Act, are an integral part of an audit conducted in accordance with *Government Auditing Standards*, and should be read in conjunction with this report on the financial statements when considering the results of the audit.



Washington, D.C.
January 24, 2003

Report of Independent Accountants on Compliance with Laws and Regulations

To the Inspector General of the
National Aeronautics and Space Administration:

We have audited the accompanying consolidated balance sheet of the National Aeronautics and Space Administration (NASA) as of September 30, 2002, and the related Consolidated Statements of Net Cost and Changes in Net Position, Combined Statement of Budgetary Resources and Consolidated Statement of Financing for the year then ended and have issued our report thereon dated January 24, 2003. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of NASA 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 laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to NASA.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and 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. The results of our tests disclosed instances, described below, where NASA's financial management systems did not substantially comply with Federal financial management systems requirements and applicable Federal accounting standards.

We reported that NASA has material weaknesses related to (1) internal controls surrounding Property, Plant and Equipment and Materials as well as (2) its processes for preparing its Financial Statements and Performance and Accountability Report. In addition, we noted a reportable condition with regard to the general controls environment over NASA's IT architecture that process financial applications. We believe that these matters, taken together, represent substantial noncompliance with the Federal financial management systems

requirements under FFMIA. Further details on these findings, together with our recommendations for corrective action have been reported separately to NASA in our report on internal control dated January 24, 2003.

We believe that NASA should assign priority to corrective actions for these FFMIA related matters consistent with the requirements of OMB Circular No. A-50, revised, on audit follow-up.

The results of our tests of compliance disclosed no other instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

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.

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



Washington, D.C.
January 24, 2003

Report of Independent Accountants on Internal Control

To the Inspector General of the
National Aeronautics and Space Administration:

We have audited the accompanying Consolidated Balance Sheet of the National Aeronautics and Space Administration (NASA) as of September 30, 2002, and the Consolidated Statements of Net Cost and Changes in Net Position, Combined Statement of Budgetary Resources and Consolidated Statement of Financing for the year then ended, and have issued our report thereon dated January 24, 2003. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered NASA's internal control over financial reporting by obtaining an understanding of NASA's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls. We limited our internal control testing to those controls necessary to achieve the objectives described in Office of Management and Budget (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, such as those controls relevant to ensuring efficient operations. The objective of our work was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the 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 (AICPA), reportable conditions are matters 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 record, process, summarize, and report financial data consistent with the assertions by management in the 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 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. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. However, we noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be material weaknesses and a reportable condition under standards established by the AICPA and OMB Bulletin No. 01-02.

Material Weaknesses:

A. NASA Lacks Adequate Controls to Reasonably Assure that Property, Plant and Equipment and Materials Are Presented Fairly in the Financial Statements

The Property, Plant and Equipment (“PPE”) and Materials accounts were reported together as a material weakness in FY 2001 due primarily to the lack of controls related to valuing the International Space Station (ISS), and valuing and classifying contractor-held property and materials, which, together with other scope limitations, led to our disclaimed opinion on the FY 2001 financial statements. As a result of the FY 2001 issues, we expanded the FY 2002 substantive testing scope for these accounts, which identified additional control deficiencies and material errors. As a result, we again expanded the scope of our substantive testing of PPE and Materials. We determined this further expansion of scope was necessary to compensate for these deficiencies in NASA’s controls surrounding these two areas. We designed the expanded testing to reasonably assure the detection of material errors that NASA would need to correct so that PPE and Materials are presented fairly in the FY 2002 financial statements.

Contractor-Held Assets and Work-in-Process

NASA’s PPE and Materials held by Contractors include land, buildings, structures, equipment, work-in-process, and materials. Combined, these categories comprise \$10,854 million, or 31.0% of net PPE and \$2,197 million, or 99.5% of net Materials, at September 30, 2002.

Federal Acquisition Regulations (FAR) require contractors to maintain detail property records for the NASA-owned, contractor-held items. Annually, contractors report aggregated PPE and Materials information to NASA using NASA Form 1018, NASA Property in the Custody of Contractors (NF 1018). NASA uses the NF 1018 reports to update its accounting records and as the basis for reporting Contractor-Held PPE and Materials balances in its financial statements. However, the NF 1018 reports are not integrated with the Agency’s financial systems and as a result require substantial manual effort at year-end and result in a number of material year-end adjustments. We believe that because NF 1018 reporting is conducted once a year and occurs at year-end, Contractor-Held PPE and Materials balances are more susceptible to potential error and misstatement.

FY 2002 testing of Contractor-Held PPE and Materials identified the following deficiencies at various contractors:

- **Work-In-Process.** In general, there is a pervasive lack of adequate internal controls and consistency in the policies and procedures for PPE and Materials. This was especially true surrounding the internal controls for calculating and reporting Work-in-Process (WIP), whereby material errors were reported by contractors in FY 2002 (see details below).

Testing results disclosed that many of the contractors tested failed to report WIP to NASA as required, as well as contractors who reported WIP but lacked adequate policies and procedures for reporting WIP on the NF 1018. Adequate policies and procedures are essential to ensure that the value reported on the NF 1018 for any item of PPE and Materials, including WIP, accurately reflects the cost incurred to bring items included in WIP to their current levels of completion. This is a significant area of importance to NASA given the number of contractors responsible to account for NASA property and the significance of property in their possession.

NASA contractors also use various methods to report WIP because the NF 1018 reporting instructions and NASA FAR Supplement are unclear on how to calculate and report WIP. The result of which was instances of contractors not knowing how to calculate WIP or what to include and/or exclude within WIP. For example, in some instances certain contractors reported costs not yet incurred within WIP. We also noted other instances whereby contractors did not include in WIP all costs incurred to fabricate the assets.

FY 2002 testing also noted the lack of internal controls at NASA Headquarters to carry out its oversight responsibility for Contractor-Held PPE and Materials.

- Obsolete WIP and Materials. NASA lacks a formal policy and procedure to record obsolete WIP and Materials on NF 1018. During FY 2002, certain contractors classified significant WIP and Materials costs as “no longer required” (NLR) or obsolete and reported those costs on the NF 1018 as errors from prior periods. Prior to FY 2002, the contractors held these items in plant clearance (items set aside waiting for disposal). However, due to the lack of clear reporting instructions on the NF 1018 for obsolete items, the contractors were unaware that they were required by the NF 1018 or NASA FAR Supplement to classify and report these NLR WIP and Material items as obsolete to NASA at year-end. NASA Headquarters internal controls for this aspect of contractor reporting are also insufficient to detect these significant reporting errors.
- Inadequate Documentation. NASA lacks of proper documentation to support certain PPE items at various contractors, most notably WIP and Materials. During FY 2002, there were numerous instances where the support for selected test items could not be located with any ease or efficiency, resulting in a substantial number of significant adjustments to the PPE balance based upon estimates of asset values reported by the Contractors.
- Detecting and Correcting NF 1018 Errors. NASA lacks adequate internal controls and formal policies and procedures to detect and correct errors reported on the NF 1018 (1) by NASA for its contractors and (2) by the contractors for their subcontractors. There was a pervasive lack of adequate review by contractors of the WIP reported on the NF 1018, which resulted in significant reporting errors on the contractors’ NF 1018’s. FY 2002 testing also indicated a consistent lack of adequate contractor review of the WIP reported

by the subcontractor to the contractors for reporting to NASA. Finally, we noted that policies and procedures established by the contractor do not consistently require that contractors report errors to NASA on a timely basis. As the result of FY 2002 testing, errors were discovered on the FY 2001 NF 1018 submissions at various contractors.

- Corrective Action. During the FY 2002 audit, we found that FY 2001 recommended corrective actions at individual contractor locations were still unresolved at September 30, 2002. In addition, new corrective actions and deficiencies were identified during FY 2002.

Such deficiencies and inadequate controls described above result in NASA not being able to reduce to a relatively low level the risk that, in the normal course of performing their assigned functions, NASA's employees and its contractors would be able to identify and detect errors and misstatements material to the financial statements within a timely period. Therefore, we expanded the scope of our substantive testing of PPE and Materials considerably to compensate for these control deficiencies. We designed the expanded testing to reasonably assure the detection of material errors that NASA would need to correct so that PPE and Materials are presented fairly in the FY 2002 financial statements. FY 2001 material errors totaling a net of \$2.8 billion were identified in the FY 2002 audit. Of this amount, we identified the following FY 2001 errors:

- One contractor revalued September 30, 2001 ISS capitalization resulting in NASA prior period adjustments of approximately (\$1,901) million to Contractor-Held WIP and (\$887) million to NASA-Held Assets in Space.
- Certain other contractors erroneously reported PPE as Materials. This resulted in a prior period balance sheet reclassification that increased PPE and decreased Materials by \$2,691 million, respectively. As a result of this FY 2001 error correction, an additional prior period adjustment of \$1,081 million was also recorded for the associated accumulated depreciation.
- One contractor misreported obsolete WIP and Materials resulting in prior period adjustments of \$432 million.
- One contractor misreported PPE as WIP for assets delivered previously to NASA and were double counted in prior years as both Contractor-Held WIP and NASA Assets-in-Space. This resulted in an adjustment of \$750 million.
- Several contractors erroneously misreported WIP in accordance with the NASA FAR Supplement, resulting in prior period adjustments of (\$385) million.
- Certain other contractors reported other agency's PPE & materials totaling \$344 million as NASA property on the NF 1018.

- Other contractors reported significant errors in the FY 2001 NF 1018's, totaling approximating (\$130) million.

NASA's current 1018 reporting process provides no transparency into the annual activity of the most significant Contractor-Held PPE, Materials and WIP. Thus, as it currently stands, in any year it is not practical to test these accounts and gain significant audit efficiencies by testing additions and deletions throughout the year, as is ordinarily the case when testing property.

In addition, until NASA's current 1018 reporting process is modified to require more periodic filings (e.g. quarterly), interim reporting for the PPE and Materials accounts will not be timely or useful. The changes in prior and current year balances for Contractor-Held property are reported as "Changes in Funded Property" in NASA's Statement of Net Costs. Changes in Funded Property are expensed throughout the year and, when applicable, are capitalized through adjustments only at year-end. Failing to recognize capitalized costs during the year will result in NASA overstating net costs and understating Property and Materials at interim.

Unless addressed in FY 2003, the above control deficiencies and the current reporting requirements will prove to be significant impediments to the Agency's ability to successfully meet accelerated reporting deadlines in FY 2004.

NASA-Held Assets-in-Space and Work-in-Process

The NASA-Held Assets in Space and NASA Held WIP comprise \$21,575 million, or 61.7%, of NASA's overall net PPE at September 30, 2002.

FY 2002 testing identified a lack of internal controls for NASA-Held Assets in Space and NASA-Held WIP as well as a lack of adequate oversight by NASA Headquarters to identify deficiencies in the design and operation of internal controls for these two asset areas. As a result of material errors identified during the FY 2002 audit, we increased substantive testing multiple times to compensate for the control deficiencies surrounding these two areas. We designed the expanded testing to reasonably assure the detection of material errors that NASA would need to correct so that PPE and Materials are presented fairly in the FY 2002 financial statements.

During FY 2002 testing, we identified the following deficiencies and errors at NASA Headquarters, which resulted in additional FY 2001 errors of (\$2,151) million:

- After review of its significant contracts, we concluded that NASA failed to include certain costs as capitalized assets in the NASA-Held Assets in Space and NASA-Held WIP accounts. There is also no systematic process to analyze launch costs and other

capitalizable support costs associated with space hardware under construction. As a result, certain costs were not capitalized until detected by our FY 2002 substantive testing.

- NASA policies and procedures also do not specifically address purchasing software as part of a package of products and services (e.g., hardware, training, maintenance, data conversion, reengineering, site licenses and rights to future upgrades and enhancements). In accordance with FASAB Statement No. 10, *Accounting for Internal Use Software* ("FASAB No. 10"), capitalizable and noncapitalizable costs of the package must be properly allocated among individual elements on the basis of a reasonable estimate of their relative fair values. FY 2002 testing resulted in errors of for costs that were originally expensed but should have been capitalized in accordance with FASAB No. 10.

In summary, the internal control deficiencies at NASA Headquarters resulted in capital costs erroneously recorded as expenses in prior years being credited against FY 2002 costs of operations. The significance of these errors reported plus the required expansion of testing indicate a lack of controls at NASA Headquarters surrounding these NASA-Held Assets in Space and NASA Held WIP and indicate the impact of not having a fully integrated financial system.

Detailed results of all findings regarding individual contractors have been communicated to management directly as well as in separate reports.

FY 2001 Recommendations:

During FY 2002, NASA demonstrated some progress addressing and implementing certain FY 2001 recommendations. However, we believe the following recommendations are still open:

1. We recommended that NASA develop cost allocation policies to guide its financial and program managers in determining and documenting allocations of costs, including launch costs, to the ISS. During FY 2002, NASA management substantiated the reported value of ISS by developing cost allocation procedures for ISS for both the September 30, 2001 and 2002, balances. However, formal cost allocation policies still have not been created to formalize these ISS capitalization policies.
2. We recommended that, as NASA addresses our FY 2001 recommendations related to the ISS, the Agency should apply these same corrective action plans to other significant assets currently held in work-in-process pending the beginning of each asset's mission. As explained above, there are material errors reported in FY 2002, which led to an expansion of substantive audit testing to compensate for and overcome these reported deficiencies to obtain reasonable assurance that PPE and Materials are presented fairly in the FY 2002 financial statements.
3. We recommended the following relating to NASA's NF 1018:

- a. NASA should revise the NF 1018 definitions and reporting instructions so that consumable materials are reported separately from items to be built into long-lived assets, consistent with FASAB and OMB form and content reporting requirements. The NF 1018 was not revised as recommended last year and given the results of FY 2002 testing and the imminent acceleration of financial reporting deadlines, we believe this recommendation to be even more imperative.
- b. NASA should revise its NF 1018 to provide additional information that would allow NASA to conduct a more rigorous analysis of the NF 1018 reports and better enable it to provide reasonable assurance that PPE and Materials balances are properly aggregated and classified by the contractors. Specifically, the 1018 should provide information from the contractors regarding additions and deletions to construction-in-progress, materials, and work-in-process as well as transfers of assets among contractors and with NASA. NASA should also obtain detailed data supporting balances reported for materials and PPE in the NF 1018 reports and use this data to validate the contractor-submitted information. In particular, NASA should conduct an analysis of contractor data on the specific items comprising the materials balances reported by the contractors to determine the proper classification of these assets within the consolidated balance sheet.
- c. NASA should ensure that the 1018 reporting instructions are clarified and updated regarding the use of estimated costs by the contractors. If the use of estimated costs is not permitted, then the reporting instructions should be updated to specifically preclude the use of estimates. If NASA determines that the use of estimated costs is appropriate for assigning values to finished equipment, then NASA should implement appropriate controls to determine the reasonableness of the contractor estimation techniques as referenced in SAS No. 57, *Auditing Accounting Estimates*. As mentioned above, insufficient revisions were implemented as recommended last year. Coupled with the results of the FY 2002 testing, this indicates that NASA still lacks controls surrounding Contractor-Held PPE and Materials and the contractor reporting process to reasonably assure the accuracy of the data reported by the contractors and that data's consistency with GAAP. As such, we believe this recommendation to be even more imperative as well.

We also recommended that NASA have regular dialogue with and increased monitoring of contractors to minimize the risk of errors on the 1018 reports. During FY 2002, NASA demonstrated progress and through monitoring of certain contracts detected material errors in the September 30, 2001 NF 1018 submissions. However, notwithstanding those efforts, based upon the results of the FY 2002 testing, NASA still lacks controls surrounding Contractor-Held PPE and Materials and the contractor reporting process to reasonably assure the accuracy of the data reported by the contractors and that data's consistency with GAAP. Consequently, we believe this recommendation to be even more imperative.

FY 2002 Recommendations:

In addition to our FY 2001 Recommendations, we identified new recommendations from FY 2002 testing. Our FY 2002 recommendations for the deficiencies cited in the narrative above are as follows:

4. We recommend that NASA create an overall detailed FY 2003 Corrective Action Plan to remedy deficiencies communicated within this report (current year deficiencies as well as those still open from FY 2001) and establish deadlines and accountability internally at NASA and at contractors to ensure all are resolved in FY 2003. As part of this plan, NASA should formalize the policies and procedures described above at all contractor locations and, where applicable, at NASA Headquarters and its Centers. Once the policies and procedures are updated and implemented to include effective internal controls, we recommend that NASA ensure that the policies and procedures are consistently and correctly applied throughout NASA.

We also recommend that, as part of the Corrective Action Plan, NASA management prioritize all findings and recommendations identified in this report and work closely with its contractors to ensure all of the findings and recommendations are resolved in FY 2003. NASA should require its contractors to create their own individual Corrective Action Plans that identifies each contractor's respective findings and recommendations. The contractors' Corrective Action Plan should include timelines and milestones that link the findings and recommendations to the overall NASA Corrective Action Plan deadlines. Prioritizing all the findings and recommendations is a critical element if NASA management intends to resolve these deficiencies and remove impediments to meet the accelerated reporting requirements in FY 2004.

Given the importance of resolving these issues, we recommend that NASA create a senior management team comprised of finance, program management, legal, procurement and others to address and resolve these findings and recommendations as soon as possible. Working backwards from the FY 2004 reporting deadlines, NASA should establish a detailed strategic plan that will consider all barriers to success and the correlating proposed solutions.

5. We recommend that NASA perform a comprehensive review of the NASA FAR Supplement and NF 1018 to ensure that all contractor requirements contained therein meet NASA's needs for financial statement reporting purposes and are in accordance with generally accepted accounting principles. To the extent applicable and necessary, NASA should identify and revise essential areas in the NASA FAR Supplement and NF 1018 instructions that need clarification. This would include issues from the FY 2001 recommendations that remain open in FY 2002 (see above) as well as those issues identified from FY 2002 testing, including:

- a. WIP – NASA should create guidance that identifies the acceptable methods for calculating and reporting WIP. The guidance should be consistently applied by all contractors and should state at a minimum: what is required, how to calculate WIP, what is included and excluded from WIP, and how WIP should be reported.
 - b. Obsolescence – NASA needs to clarify the contractors’ responsibilities for identifying and reporting obsolete and NLR WIP and materials.
 - c. Supporting Documentation – Overall, NASA should enhance its requirements to document assets transferred to/from NASA Centers and/or other contractors, including the related transfer forms (e.g., 1149, DD-250 et al...). We recommend that NASA require its Centers and contractors maintain full supporting documentation for all property and specifically for asset transfers. Full supporting documentation means including the appropriate dollar amount of the asset transferred and the formal, signed NASA or contractor authorization approving the transfer. Delivery of the asset should not be approved until NASA determines that both of these requirements are properly documented. Full supporting documentation will provide a detailed audit trail and establish proper cost support.
6. We recommend that NASA enhance its requirements to determine the adequacy of the contractor’s review of the property reported on the NF 1018. The requirement should also include a provision for the contractor to review the property reported by its subcontractors on the NF 1018. During our FY 2002 testing, this deficiency mainly applied to WIP.
7. We recommend that NASA management provide comprehensive training to its Property Administrators and contractors on the following, at a minimum:
- a. Differences in property accounting (NASA FAR Supplement and NF 1018 requirements) and financial reporting requirements (GAAP); and,
 - b. NF 1018 findings and recommendations in the current and prior years.

We recognize that NASA may have provided this training in prior years; however, given the prevalence and significance of the errors in FY 2002 as well as the amount of substantive testing required to compensate for these errors and identified deficiencies, we recommend that NASA management provide this training with a focus on the deficiencies identified in FY 2002, as well as those still open from FY 2001.

8. We recommend that NASA ensure that all of its contractors have formal policies and procedures to detect and correct errors reported on the NF 1018. The policies and procedures should include a provision that requires the contractors to report Property correctly to NASA. If and/or when errors are detected, the policy should state that the contractors must communicate the issue to NASA on a timely basis (e.g., within one month of identification).

9. We recommend that NASA Headquarters strengthen its internal controls to improve its oversight responsibility for: (a) contractor-held PPE, (b) materials, (c) NASA-held assets in space, and (d) NASA-held WIP.

For example, NASA Headquarters should:

- Conduct staff training
 - Establish internal checklists to be completed each reporting period going forward (e.g., quarterly) detailing required procedures to be performed while reviewing the assets
 - To the extent applicable, formalize and update policies and procedures quarterly
 - Establish an internal action plan that requires periodic reviews of (a) key contractors' NF 1018s and (b) critical policies and procedures (e.g., reporting of WIP) on a rotational basis.
10. We recommend that NASA create formal policies and procedures to ensure all appropriate costs are capitalized as part of NASA-Held Assets in Space and NASA-Held WIP accounts. We also recommend that NASA strengthen its internal controls surrounding these two account areas to reflect these changes, including a systematic process to analyze launch costs and other capitalizable support costs associated with space hardware under construction.
11. We recommend that NASA enhance its current policies and procedures to specifically address purchasing software as part of a package of products and services (e.g., hardware, training, maintenance, data conversion, reengineering, site licenses and rights to future upgrades and enhancements). NASA must properly allocate capitalizable and noncapitalizable costs and document the commensurate support for each. We also recommend that NASA strengthen its internal controls surrounding this area to reflect these changes.
12. We recommend that NASA modify its NF 1018 reporting requirements for its contractors as soon as possible in FY 2003 to require more periodic and timely submissions (e.g., quarterly). Given the number of NASA contractors, we understand that this will be a significant undertaking because it will involve regulatory, contractual, funding, and business process changes at NASA and its contractors. These changes will directly impact NASA's ability to process these critical modifications next year.

NASA must modify and update its own internal controls and policies and procedures in addition to those at all of their contractors to accommodate the accelerated financial statement reporting date. Therefore, we recommend that NASA proactively identify the policies, procedures, and internal controls that will be impacted by the OMB accelerated reporting due date and ensure that such policies, procedures, and internal controls are included in the Corrective Action Plan.

If all NASA's reporting requirements are not immediately resolved in FY 2003, we believe this will be the largest impediment to the Agency's ability to meet FY 2004 accelerated reporting deadlines. Until NASA's current NF 1018 reporting process is modified and the above changes have been fully implemented and resolved, we recommend that NASA disclose in all future interim report filings that its interim financial statements are materially misstated because contractor property is only reported annually and certain capital expenditures are reported as expenses.

B. NASA's Processes for Preparing Its Financial Statements and Performance and Accountability Report Need Improvement

Our testing of NASA's compilation of its financial statements identified a material weakness in NASA's process for preparing its financial statements and performance and accountability report. This material weakness was not reported on in NASA's FMFIA report. Significant errors uncovered included the following:

- Errors were made in recording significant adjustments to the financial statements, and some material adjustments that were supposed to have been recorded were not.
- One of the versions of the Statement of Net Position and the Statement of Financing included a material error representing a GAAP and OMB Bulletin 01-09 departure. NASA included as part of these statements a prior period adjustment that, per NASA, reflected the impact of the restatement performed on their FY 2001 financial statements. NASA misinterpreted available guidance and believed that since a restatement was performed in the prior year, a prior period adjustment was required during the current year to reflect the change in beginning cumulative results of operations.
- The original version of the Combined Statement of Budgetary Resources contained the line item "Total Budgetary Resources" that did not agree to the line item "Status of Budgetary Resources." Failure of these two items to reconcile exactly indicated a high likelihood of error in this statement.
- The original version of NASA's Consolidated Statement of Financing omitted the following line items: budgetary offsetting collections and receipts that do not affect net cost of operations-other; and resources that finance the acquisition of assets.

We also noted significant departures from the requirements of OMB Bulletin 01-09 in drafts of the management's discussion and analysis ("MD&A") and required supplementary stewardship information ("RSSI") on investments in research and development that NASA had provided to us.

NASA corrected all significant errors and departures from Bulletin 01-09 prior to the release of the final FY 2002 Financial Statements. However, these errors and departures should have been identified and corrected by NASA management during its internal quality control review of this information. We believe these errors are indicative of material weaknesses in NASA's controls over the compilation of its financial statements, MD&A and RSSI. These weaknesses appear to result from a combination of one or more of the following: (1) insufficient resources to address the volume of compilation work, (2) lack of an integrated financial management system, (3) lack of understanding by NASA staff of new federal reporting requirements, and (4) lack of quality controls over financial reporting, including preparation of the MD&A and RSSI.

Once fully implemented in FY 2004, NASA's Integrated Financial Management Program ("IFMP") is expected to relieve some of the workload associated with compiling the annual financial statements (e.g., it will no longer be necessary to consolidate data from 10 different financial systems). Regardless, other improvements in NASA's financial reporting process are necessary as well to help assure the Agency can prepare reliable annual and unaudited interim financial statements within accelerated deadlines in FY 2004.

Recommendations:

- We recommend that NASA improve its financial reporting internal quality review procedures to reasonably assure that information presented on the financial statements, footnote disclosures, MD&A, and RSSI are accurate and are consistent with the requirements of OMB Bulletin 01-09. To ensure the accuracy and completeness of work performed, supervisory reviews should be guided by preparation of standard checklists, such as that included in the General Accounting Office's *Financial Audit Manual* and additional technical training for staff.
- We recommend that analytical procedures be completed to ensure logical relationships exist between various financial statement amounts, and that the relationships between the different statements and line items within each statement are appropriate. Variances from expected results should be thoroughly researched and resolved. Consistent use of standard checklists can also ensure these procedures are applied.
- We recommend that NASA follow up its investment in IFMP with an investment in training and tools to support the preparation of reliable interim and year-end financial statements, MD&A, and RSSI that meets OMB form and content requirements.
- We recommend that senior NASA financial management devise a NASA-wide detailed timeline with specific milestones to ensure ample time and resources are available to complete the following tasks associated with preparing the financial statements and other

elements of the performance and accountability report: (1) data collection; (2) data validation; (3) data compilation; (4) detailed quality review.

Reportable Condition:

During FY 2002, we noted a reportable condition with regard to the general controls environment over NASA's IT architecture that process financial applications. Specifically, we identified the following deficiencies related to this area:

- Lack of Comprehensive Disaster Recovery Test of Logical Partitions that Process Significant Financial Applications - This issue was noted as a Reportable Condition in our FY 2001 internal controls report. While the NASA Automated Data Processing Consolidation Center ("NACC") has developed a test schedule to test all logical partitions within a period of one year, a test to execute such a plan has not been completed. As a result, NACC has limited assurance that, in the event of a disaster, all logical partitions that support the financially significant applications can be restored simultaneously.
- Inadequate Logical Access Controls over Security of Financial Management Systems - This issue was noted as a Reportable Condition in our FY 2001 internal controls report. While NACC has taken corrective measures to resolve the logical weaknesses noted in our FY 2001 report, we continued to note additional weaknesses in the IT architecture supporting the financially significant applications based on incremental testing performed in FY 2002. In addition, NASA Procedures and Guidelines document, NPG 2810.1, dated August 26, 1999, was noted as not being in compliance with Federal mandated security and business practice standards as prescribed within OMB Circular No. A-130 (Management of Federal Information Resources), Appendix 3.
- NASA Automated Data Processing Consolidation Center (NACC) Emergency Fire-Call Identification Practice and Revocation Process of Systems Programmer Emergency Access Privileges Can Be Enhanced - Our testing as part of the FY 2002 audit revealed weaknesses in the process to assign and revoke emergency access privileges. This issue was noted as a Management Letter Comment in FY 2001. Although NACC is taking steps to resolve this issue, we are elevating the status of this issue to a Reportable Condition in FY 2002 given that the emergency identifications with powerful privileges are available to the System Programmers at all times. In addition, we did not evidence any "concrete" corrective action plan that was being considered to implement an automated emergency fire-call ID process.
- Inappropriate User Access to Security Software Super User Capabilities Over the Logical Partitions Supporting the MSFC and KSC Financial Data - In the absence of adequate controls that restrict access to such powerful privileges, there is a risk that unauthorized activity by security administrators on these logical partitions could go undetected.

- Change Control Procedures for the STARS Application at KSC Need Enhancement - Our testing revealed deficiencies in the KSC's change control procedures for the STARS production application environment supporting the need for improvement of existing change control practices and procedures.
- Inappropriate "Write" (Update) Access to Financial Production Data for KSC and MSFC - Inappropriate access such as this could compromise the KSC and MSFC financial data in the production environment. During FY 2002, we noted several instances of inappropriate and unnecessary update access to KSC and MSFC production financial system data.

We have included a detailed discussion of the findings and related recommendations in the "Reportable Conditions" section of the FY 2002 IT management letter.

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In addition, we considered NASA's internal control over required supplementary stewardship information by obtaining an understanding of NASA's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02 and not to provide assurance on these internal controls; accordingly, we do not provide an opinion on such controls.

Finally, with respect to internal controls related to performance measures reported in the FY 2002 Performance and Accountability Report, Management's Discussion and Analysis - Highlights of Performance Goals and Results, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Our procedures were not designed to provide assurance on internal control over reported performance measures; accordingly, we do not provide an opinion on such controls.

We also noted certain other matters involving internal controls that we will report to NASA management in a separate management letter.

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



Washington, D.C.
January 24, 2003