

Office of Inspector General
Washington, DC 20546-0001



NOV 15 2004

TO: Administrator
Chief Financial Officer

SUBJECT: Audit of the National Aeronautics and Space Administration's
Fiscal Year 2004 Financial Statements

Under the Chief Financial Officers Act of 1990, NASA's financial statements are to be audited in accordance with generally accepted government auditing standards. The Office of Inspector General selected the independent certified public accounting firm Ernst & Young LLP (E&Y) to audit NASA's financial statements in accordance with *Government Auditing Standards* and Office of Management and Budget's (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In the enclosed *Report of Independent Auditors*, E&Y disclaimed an opinion on NASA's financial statements for the fiscal year ended September 30, 2004. The disclaimer resulted from NASA's inability to provide E&Y auditable financial statements and sufficient evidence to support the financial statements throughout the fiscal year and at year-end.

The E&Y *Report on Internal Control* includes five reportable conditions of which four are considered to be material weaknesses. Material weaknesses were found in NASA's controls for: (1) financial systems, analyses and oversight used to prepare the financial statements, (2) reconciling differences in the Fund Balance with Treasury, (3) assuring that property, plant, and equipment and materials are presented fairly in the financial statements, and (4) securing the computing environment that supports the Integrated Financial Management Program. The final reportable condition concerns weaknesses in NASA's controls for estimating environmental liability.

The E&Y *Report on Compliance with Laws and Regulations* identifies several instances in which NASA's financial management systems did not substantially comply with *Federal Financial Management Improvement Act (FFMIA)* requirements. For example, the report notes that certain subsidiary systems, including property, are not integrated with the Core Financial Module. The report also questions whether the Agency fully complied with the *Improper Payment Information Act of 2002* because NASA's risk assessment focused on payments related only to firm-fixed price contracts and because the Agency did not prepare an estimate of improper payments.

Many of the issues identified by E&Y are attributable to implementation problems and weaknesses in the Core Financial Module, which is the backbone of the Agency's

Integrated Financial Management Program. We believe that a lack of consistency in the way financial data was processed in the less disciplined legacy environment contributed to the data conversion and integrity problems the Agency is now facing. While the Agency faces a formidable challenge completing implementation of the Integrated Financial Management Program, we believe the decision to implement a single integrated Agency-wide system was correct. Had the Agency not elected to implement an integrated financial system, we sincerely doubt that even heroic efforts by NASA and its auditor using the legacy systems would have resulted in reliable financial reporting within the accelerated time frames now required of Executive Branch agencies. Replacing the disparate legacy accounting systems at the nine NASA Centers and Headquarters with an integrated financial system represents a critical step to improving the Agency's financial management.

To address the weaknesses that E&Y reported, NASA should finalize and implement its Financial Management Improvement Plan with particular emphasis on:

- Ensuring that the Chief Financial Officer's Office is staffed to address the Agency's financial management and accountability challenges.
- Ensuring that accounting policies and procedures are consistent with applicable standards and are consistently applied.
- Establishing internal controls that provide reasonable assurance that the financial statements are supported, complete and accurate.
- Identifying and correcting data conversion and integrity problems in the Core Financial Module.
- Implementing recommendations made in E&Y's *Report on Internal Control*, and those made by our office and the Government Accountability Office.

E&Y is responsible for each of the enclosed reports and the conclusions expressed within. Accordingly, we do not express an opinion on NASA's financial statements, internal controls over financial reporting, or compliance with certain laws and regulations including, but not limited to, FFMIA.

In fulfilling our responsibilities under the Chief Financial Officers Act of 1990, we provided oversight and technical support. We monitored the progress of the audit, reviewed reports submitted by E&Y, and ensured that they met contractual requirements.



Robert W. Cobb

3 Enclosures

Report of Independent Auditors

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

We were engaged to audit the accompanying consolidated balance sheet of the National Aeronautics and Space Administration (NASA) as of September 30, 2004, and the related consolidated statement of net costs, statements of changes in net position and financing, and combined statement of budgetary resources for the fiscal year then ended. These financial statements are the responsibility of NASA's management. The financial statements as of September 30, 2003, and for the fiscal year then ended, were reported on by other auditors whose report dated January 20, 2004 disclaimed an opinion on those statements and described certain departures from generally accepted accounting principles regarding disclosures related to significant differences between its Fund Balance with Treasury balance per its general ledger and Treasury's reported balance, consistency of presentation of the statement of financing, and certain matters relating to a change in fiscal year 2003 in NASA's approach in allocating depreciation expenses and capitalized costs.

During fiscal year 2003, NASA implemented an Integrated Financial Management Program (IFMP) system, specifically the Core Financial Module. NASA's management identified significant errors beginning with its September 30, 2003 financial statements resulting from the implementation of the IFMP system. During fiscal year 2004, NASA's management continued to identify and resolve significant system conversion and data integrity issues, implement internal control and develop policies and procedures—much of which took place in the last quarter of fiscal year 2004. Additionally, management indicated that the Core Financial Module could not link manual adjustments/corrections to the original transaction. Further, NASA was unable to provide a subsidiary listing of outstanding balances to support certain financial statement balances including accounts payable and undelivered orders, and management was unable to represent that its financial statements were fairly stated. As a result of these limitations, we were unable to obtain sufficient evidential support for the amounts presented in the consolidated balance sheet as of September 30, 2004, and the related consolidated statement of net costs, statements of changes in net position and financing, and combined statement of budgetary resources for the fiscal year then ended.

Because of the matters discussed in the preceding paragraph, 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 as of September 30, 2004, and the related consolidated statement of net costs, statements of changes in net position and financing, and combined statement of budgetary resources for the fiscal year then ended.

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In its preparation and analysis of its September 30, 2004 financial statements, NASA's management identified certain configuration and data integrity issues and significant errors in balances reported on its financial statements. The footnotes to the financial statements describe certain departures from accounting principles generally accepted in the United States of America in NASA's fiscal year 2004 financial statements.

The information presented in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information, and the Required Supplementary Information is not a required part of the NASA's financial statements, but is considered supplementary information required by Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. Such information has not been subjected to auditing procedures, and accordingly, we express no opinion on it. We were unable to apply to the information certain procedures prescribed by professional standards within the timeframes established by OMB, because of the limitations on the scope of our audit of the financial statements, discussed above. Additionally, we were unable to assess control risk relevant to NASA's intra-governmental transactions and balances, as required by OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, because reconciliations were not performed with certain Federal trading partners as required by OMB Bulletin 01-09. Finally, as discussed in Footnote One, programs identified in the financial statements do not directly align with the major goals and outputs described in the MD&A.

In accordance with *Government Auditing Standards*, we have also issued our reports dated October 29, 2004, on our consideration of NASA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and other matters. The purpose of those reports is to describe the scope of our testing of internal controls over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our work.

Ernst + Young LLP

Washington, D.C.
October 29, 2004

Report on Internal Control

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

We were engaged to audit the financial statements of the National Aeronautics and Space Administration (NASA) as of and for the year ended September 30, 2004, and have issued our report thereon dated October 29, 2004. The report states that because of the matters discussed therein, 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 as of September 30, 2004, and the related consolidated statement of net costs, statements of changes in net position and financing, and combined statement of budgetary resources for the fiscal year then ended.

In planning and performing our work, 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, *Audit Requirements for Federal Financial Statements*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act (FMFIA) 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. We noted certain matters discussed in the following paragraphs involving the internal control and its operation that we consider to be reportable conditions. We consider the first four matters noted—Financial Systems, Analyses and Oversight; Fund Balance with Treasury; Property; and Integrated Financial Management Program (IFMP) Systems Control Environment—to be material weaknesses.

MATERIAL WEAKNESSES

Financial Systems, Analyses and Oversight (Modified Repeat Condition)

Overview

OMB Circular A-127 requires that financial statements be the culmination of a systematic accounting process. The statements are to result from an accounting system that is an integral part of a total financial management system containing sufficient structure, effective internal control, and reliable data. As more fully described in NASA's draft Financial Management Improvement Plan, in Fiscal Year (FY) 2002, NASA initiated a seven-year Agency-wide effort to provide a single, integrated suite of financial, project, contract, and human capital tools to help manage NASA's programs and prepare financial information on a timely basis consistent with evolving OMB guidance. During FY 2003, NASA implemented an Integrated Financial Management Program (IFMP) system, specifically the Core Financial Module. The Core Financial Module replaced 10 disparate Center-level accounting systems and the NASA Headquarters accounting system, along with approximately 120 ancillary subsystems in operations for the past two decades. This conversion effort necessitated complex, extensive data cleanup, which was not always successfully completed.

NASA's management identified significant errors beginning with its September 30, 2003, financial statements resulting from the implementation of the IFMP system. During FY 2004, NASA's management continued to identify and resolve significant system conversion and data integrity issues, implement internal control, and develop policies and procedures. In its preparation and analysis of its September 30, 2004, financial statements, NASA's management continued to identify configuration and data integrity issues and significant errors in balances reported on its financial statements. Additionally, NASA's management indicated that the Core Financial Module could not provide an audit trail for certain transactions and was unable to provide subsidiary listings and certain supporting documentation.

NASA continues to work towards resolving issues noted in the FY 2003 financial statement audit report related to the lack of an integrated financial management system and inadequate financial accounting and supervisory review processes. Management reported certain actions, including:

- Financial Statement Preparation. Although management acknowledges weaknesses in the underlying data which preclude reliance on the statements at this time, IFMP has been configured to crosswalk standard general ledger accounts to the financial statements and selected notes to the financial statements, in accordance with OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, and the United States Standard General Ledger crosswalks prescribed by the Department of the Treasury (Treasury). Accordingly, the financial statements are produced directly from IFMP.

- Policies and Procedures. NASA published eight volumes of the new NASA Financial Management Requirements: Budget Execution, Accounting, Cost, External Reporting, Anti-Deficiency Act, Contract Financial Management, Grant Financial Management, and Working Capital Fund Policies and Requirements. Supplemental policy guidance was distributed for property, full cost implementation, and reimbursable agreements.
- Property. In addition to publishing definitive property, plant and equipment policy in the NASA Financial Management Requirements document in September 2004, major contracts were amended to require monthly reporting of property values. Process improvements in valuation practices and increased oversight by NASA and outside reviewers are included in ongoing efforts to improve reporting by contractors.
- Fund Balance with Treasury. NASA continues to make progress in resolving its Fund Balance with Treasury imbalance. While not completely reconciled, major differences identified in the FY 2003 financial statement audit have been researched and we were informed that many have been corrected. Corrective actions will continue into FY 2005.
- Organization Structure. NASA reorganized its operations so that certain procurement functions and the Chief Financial Officer (CFO) functions within the Centers report directly to NASA's CFO. Additionally, as part of the reorganization, NASA established a quality assurance office in the Office of the CFO to evaluate the efficacy of agency-wide management controls.

Although progress was made, significant financial management issues continue to impair NASA's ability to accumulate, analyze, and distribute reliable financial information. Our review of the internal control disclosed numerous weaknesses in NASA's ability to report accurate financial information on a timely basis. NASA's Core Financial System lacks integration with certain subsidiary systems, does not facilitate the preparation of the financial statements, and contains insufficient internal control to detect and support the correction of invalid entries in a timely fashion. Additionally, NASA personnel were not consistently utilizing uniform accounting processes that record, classify, and summarize information for the preparation of financial statements. Finally, NASA lacked formalized procedures to analyze accounting data, and sufficient source documentation to support reported financial information. Integrated financial systems, a sufficient number of properly trained personnel, and a strong oversight function are needed to ensure that periodic analyses and reconciliations are completed to detect and resolve errors and irregularities in a timely manner.

Lack of Integrated Financial Management System

The NASA financial management systems are not compliant with the Federal Financial Management Improvement Act of 1996 (FFMIA). FFMIA requires agencies to implement and maintain financial management systems that comply with Federal financial management systems requirements as defined by the Joint Financial Management Improvement Program (JFMIP). More specifically, FFMIA requires Federal agencies to have an integrated financial management system that provides effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. The lack of an integrated

financial management system continues to impair NASA and the Centers abilities to adequately support and analyze account balances reported.

Although NASA implemented a commercial off-the-shelf financial module approved by the JFMIP, certain aspects of the NASA accounting system lack integration and does not conform to the requirements currently specified by the JFMIP. As identified in Footnote Sixteen to the financial statements, NASA's management continues to identify data integrity and configuration issues in the Core Financial System which results in inappropriate transactional postings. Additionally, the Core Financial System is unable to provide detailed listings of balances to support NASA's September 30, 2004, reported balances. Finally, certain subsidiary systems, including property, are not integrated with the Core Financial System. Specific weaknesses noted include:

- During our audit work, we were unable to obtain a listing of balances from the Core Financial System. Specifically, we were unable to obtain a listing of balances to support accounts receivable, accounts payable, and undelivered orders to support financial statement amounts as of September 30, 2004. Additionally, NASA was unable to provide subsidiary listings of cash receipts and cash disbursements to support their budgetary outlays during the fiscal year. Currently, the Centers are able to provide certain subsidiary listings; however, the listings are being generated from ad-hoc processes, not directly from the Core Financial System.
- The Core Financial System does not provide for tracking manual of non-routine or correction entries with linkage back to the original transaction or the capability to isolate manual adjustments. As a result, adjustments and corrections cannot be readily identified.
- Certain subsidiary systems, including property, are not integrated with the Core Financial System. Entries for contractor-held property, totaling \$8.5 billion, are recorded into the Core Financial System using manual vouchers.
- NASA's management continues to identify certain transactions that are being posted incorrectly due to improper configuration within the Core Financial System.
- Due to systematic limitations, NASA Centers are developing alternative approaches to ensure data and financial management information is readily available to make critical decisions. These alternatives are inconsistent between Centers and may cause varied results in reporting from the Centers to Headquarters.

Financial Statement Preparation and Analysis

During FY 2003, NASA implemented the Core Financial Module of the IFMP system. Because of the complexity of its conversion and the pervasiveness of errors identified in the Core Financial Module as of September 30, 2003, financial statements amounts reported were found to be unreliable and not complete. Specific issues identified related to data integrity issues, limitations requiring system configuration updates, lack of sufficient audit trails and

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documentation, incorrect transactions within the Core Financial Module, and insufficient analyses and weaknesses in internal control to identify material misstatements in a timely fashion.

For purposes of preparing interim financial statements during FY 2004, NASA made the decision to utilize estimates in preparing its financial reporting to OMB and Treasury because financial statements generated from the Core Financial System were deemed unreliable. The estimates were based on Treasury reports, FY 2003 balances, and/or budgetary or planned outcomes. Our review of the June 30, 2004 interim financial statements generated by the Core Financial System identified the following:

- A difference of \$5.3 billion between the assets on the balance sheet generated from the Core Financial System and the sum of liabilities and net position.
- The net costs of operations on the consolidated statement of net costs did not agree to the net costs of operations located on the statement of financing—the difference totaling approximately \$2 billion.
- Obligations incurred on the statement of budgetary resources did not agree to obligations incurred on the statement of financing—the difference totaling approximately \$4 million.

The pervasiveness of these errors prevented us from performing significant substantive audit procedures on NASA's June 30, 2004, financial statements.

Although NASA generated its financial statements from the Core Financial System at September 30, 2004, NASA's management continued to identify similar issues during FY 2004. As discussed in Footnote Sixteen of the September 30, 2004, financial statements, NASA's management reported that the correction of prior year transactions during FY 2004 resulted in misstatements to many budgetary and proprietary nominal accounts because the Core Financial System could not distinguish between current year transactions and the corrections to prior year transactions without processing the corrections as prior period adjustments or reopening FY 2003 to process the corrections as current year activity. Additionally, the data integrity issues identified during FY 2003 continued to impair FY 2004 opening balances. Finally, NASA continued to identify functionality and configuration issues that impaired its ability to prepare accurate and complete financial statements. For example, in our review of the September 30, 2004, financial statements, we noted the following concerns:

- During our testing, we identified situations where costs are not recorded properly. NASA designed its new Core Financial Module to include a system edit, whereby, if costs (and the corresponding liabilities) are greater than the associated obligations, the difference would not be recorded in NASA's general ledger but rather maintained outside of the general ledger system. Instead, the differences were adjusted at the contract/project-level by posting a liability to match the excess costs. Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, SFFAS No. 4 *Managerial Cost Accounting Concepts & Standards*, and NASA's

Financial Management Regulations require costs to be accrued in the period in which they are incurred and any corresponding liability to be recorded as an account payable, regardless of the associated amounts obligated.

- The Core Financial System was unable to provide a breakdown of costs by the four mission directorates which NASA has identified as significant segments. This is not consistent with the requirements of SFFAS No. 4.
- We noted instances where the Core Financial System did not agree to the crosswalk provided that supports the financial statements. Management indicated that manual adjustments were required to ensure accuracy in the reported balances and consistency among statements. The majority of the adjustments related to the Statement of Budgetary Resources.

Additional Controls Need to be Strengthened

The U.S. Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government states that internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the organization's control objectives. Examples of control activities include: top level reviews, reviews by management at the functional or activity level, segregation of duties, proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions and internal control.

Because significant weaknesses exist in the Core Financial System, management must compensate for the weaknesses by implementing and strengthening additional controls that will ensure errors and irregularities are detected in a timely manner. The weaknesses identified impact NASA's ability to report accurate financial information. During FY 2004, we found that certain processes were not adequately performed to ensure differences were properly identified, researched and resolved in a timely manner, and that account balances were complete and accurate. The following represents specific areas that need enhanced periodic reconciliation and analysis procedures:

- Manual or Non-Routine Transactions. The Core Financial System does not provide for tracking of non-routine or correction entries with linkage back to the original transaction. Non-routine transactions are high risk and should be closely monitored. We noted that there was no unique identifier in the system to easily access these transactions.
- Certification of NASA Center Activity. Although the majority of financial activity is processed in the Centers, the Center CFO offices are not required to (1) certify that financial transactions are complete, accurate, and have been properly recorded, and (2) perform high level analytical procedures to ensure balances are not materially misstated. Further, there is limited headquarters review of monthly financial reconciliation and analyses procedures.

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- Policies and Procedures. Until September 2004, NASA did not have formalized policies and procedures for developing its financial statements, the financial reporting analyses functions, or certain transactional processes. As a result, certain inconsistencies between Centers and Headquarters personnel were identified in the processing of similar transactions. The GAO's Standards for Internal Control in the Federal Government requires that internal control and all transactions need to be clearly documented in properly maintained management directives, administrative policies, or operating manuals. Once formalized policies are completed, personnel should be properly trained to ensure policies are properly implemented and adhered to.
- Assessment of Improper Payments. During FY 2004, NASA has informed OMB of the status of its implementation of the Improper Payment Information Act of 2002 (IPIA). In its risk assessment, NASA identified and tested only those payments related to firm-fixed price contracts from each of the centers. Although the IPIA discusses consideration of other types of payments that should be considered, including Federal awards made by recipients and sub-recipients subject to the Single Audit Act Amendments of 1996 as well as Federal grants and sub-grants expended by for-profit and non-U.S. based entities not subject to that Act, NASA did not test these payments or document the rationale for not considering these payments as part of the risk assessment.
- Documentation. We noted that adequate documentation to support certain transactions was not readily available. Our testing of transactions identified several items where we did not receive sufficient information to determine if the transaction was valid. For example, NASA could not provide documentation to support whether a grant accrual was required to be reported as part of its financial statements as of September 30, 2004.
- Correction of Errors. NASA was unable to identify and resolve errors in postings to the subsidiary ledgers and the general ledger in a timely fashion. During our testing of Undelivered Orders, we noted three transactions totalling more than \$560 million that management identified as improper transactions caused by configuration issues within the Core Financial System. Some transactions dated back as early as March 2004 but are not expected to be resolved until FY 2005. Management at the Center has requested assistance from Headquarters to resolve the issue.
- Supervision and Review. During our testing of one of the larger theme assets, we noted that NASA made a \$191 million error in calculating depreciation. The error appears to be the result of an error in a formula on a spreadsheet that the reviewer did not identify.

The GAO's *Standards for Internal Control in the Federal Government* indicates that internal control monitoring should assess the quality of performance over time and ensure that findings of audits and other reviews are promptly resolved. Without appropriate monitoring and oversight of contractor operations, deficiencies in internal control may allow material misstatements to occur without being identified in a timely manner.

Given the severity of these issues, including system and process limitations and expertise needed in the new and future financial reporting requirements, it will take a sustained commitment and a qualified support team to resolve these issues in preparation for FY 2005 and future years.

Recommendation

We recommend that NASA continue to develop and refine its financial management systems and processes to improve its accounting, analysis, and oversight of financial management activity. Specifically, we recommend NASA:

- Continue to improve its financial reporting and internal quality review procedures to reasonably assure that information presented in the Performance and Accountability report are accurate and are consistent with the requirements of OMB Bulletin No. 01-09.
- Configure the Core Financial System to provide a breakdown of net costs consistent with programs identified in NASA's strategic plan and in the Management, Discussion, and Analysis section of the Financial Statements.
- To ensure accuracy and completeness of work performed, supervisory reviews should be guided by preparation of a comprehensive checklist. For example, the process of supervisory review at Headquarters and the Centers should be enhanced to identify errors in a more timely fashion. This should include enhancements to high-level analysis; the development of an archiving mechanism so that historical information is available for future trending; and enhancements to oversight procedures to monitor the implementation of control procedures to provide independent checks of validity, accuracy, and completeness of amounts reported to NASA.
- Continue to refine its procedures to provide a mechanism for NASA Headquarters to monitor Centers' activities and enforce compliance with NASA financial management procedures. We suggest that a systematic methodology be devised to ensure that accounting policies and procedures are in compliance with generally accepted accounting principles. While the IFMP provides Center and Headquarters personnel access to certain transactions and account balance information, we encourage management to also access related support from Centers, review subsidiary ledgers for reasonableness, and obtain reconciliations and account analyses for review to ensure their timely preparation and resolution.
- Complete and document analytical procedures to ensure that 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 researched and resolved.
- Revise its 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, and (4) detailed quality review.
- Ensure that systems used to prepare the financial statements are complete and have been sufficiently tested prior to interim and year-end reporting dates. NASA should continue to validate its data within the Core Financial Module to resolve issues with data integrity

issues that date back to system conversion in 2003.

- Devise short-term and long-term resolutions to IFMP systematic and integration issues and the lack of internal controls surrounding costs in excess of obligations and downward adjustments.
- Formally document roles and responsibilities of its Headquarters, IFMP Competency Center, and Center financial management personnel to ensure appropriate accountability is achieved at each level. Additionally, we recognize that resource limitations may constrain NASA's ability to execute its mission. Management should continue to focus on filling key vacancies within the financial management organization.
- Provide additional training for financial personnel to ensure that they understand their role in processing transactions, performing account analyses and reconciliations, maintaining supporting documentation, and updating their knowledge of financial reporting requirements.

Further Research Required to Resolve Fund Balance with Treasury Differences (Modified Repeat Condition)

An agency's Fund Balance with Treasury represents monies an agency can spend for authorized transactions, which are based on budget spending authorizations and are made available through Treasury warrants. Amounts available are increased or decreased as monies are collected and disbursed. Although Treasury serves as the central processing facility for federal entities, Treasury does not maintain independent accounting records of each agency's Fund Balance with Treasury, but relies instead on monthly data reported by each agency for its record of agency collections, disbursements, and Fund Balance with Treasury.

Throughout FY 2003, NASA implemented, in phases, a commercial off-the-shelf, Agency-wide, integrated financial management system that replaced 10 separate accounting systems in operation at NASA Centers. This effort, which involved converting accounting data in the "legacy" accounting systems to a new accounting system, created complex accounting issues for FY 2003. Consequently, as noted in the FY 2003 audit report, NASA posted year-end adjustments outside its Core Financial System, which indicated that the difference between its Fund Balance with Treasury balance and Treasury's balance was significantly greater than had been presented in its year-end reconciliation. In addition, these adjustments did not provide sufficient documentary evidence to explain the linkage between the adjustments and the unreconciled differences identified on Headquarters' Fund Balance with Treasury reconciliations as of September 30, 2003.

As NASA indicated in its Management, Discussion and Analysis section of the Performance and Accountability report, we were informed that NASA has been able to resolve a substantial portion of the Fund Balance difference with Treasury. During FY 2004, the NASA Headquarters and its centers expended much effort analyzing the FY 2003 year-end adjustments to the Fund Balance with Treasury account and the impact to other related accounts. As a result, NASA classified the transactions into four major categories: document conversion, canceled

appropriations, trust fund transfer, and other reconciling items. Year-end adjustments involved thousands of transactions that were not processed through the new financial system, not coded correctly, or were included erroneously in the new system during the conversion.

Although we were informed that many errors from FY 2003 were resolved, significant errors within the accounting system are still being identified. As of September 2004, NASA had not completely identified and resolved certain errors that still exist within the Core Financial system. For example, we identified an absolute value difference of \$313 million between the Core Financial System and the Treasury balance. In addition, the total amount reported in NASA's Budget Clearing Account as of September 30, 2004 was \$19 million. These amounts may include the data conversion adjustments identified during FY 2003, as well as additional differences that have occurred throughout FY 2004. These balances will require further research to determine the cause of the errors and resulting resolutions.

Treasury regulations require that each federal entity ensure that it reconciles on a monthly basis its financial records with Treasury's records and that it promptly resolves differences. If this reconciliation is not adequately performed, loss, fraud, and irregularities could occur and not be promptly detected, and/or financial reports that are inaccurate may be prepared and used in decision-making.

Recommendation

We recommend that NASA improve its current procedures to ensure that all reconciling items are thoroughly researched, timely resolved, and reviewed by appropriate Center and Headquarters CFO personnel. In addition, NASA should retain all reports and documentation used in performing its Fund Balance with Treasury reconciliations to ensure that detailed documented explanations and resolution actions are maintained for a sufficient audit trail.

Enhancements Needed For Controls Over Property, Plant and Equipment and Materials (Modified Repeat Condition)

Consistent with prior year audit reports, our review of property, plant, and equipment (PPE), totaling approximately \$34.6 billion, identified serious weaknesses in internal control that if not corrected could prevent material misstatements from being detected in a timely manner. NASA's management acknowledged these weaknesses in its Management, Discussion and Analysis to its financial statements and its FY 2004 FFMIA Statement of Assurance.

During FY 2003, NASA's management created an overall Corrective Action Plan to remedy deficiencies identified within prior year audit reports. During FY 2004, progress was made in implementing aspects of the plan. For example, NASA:

- Established a quality assurance program, utilizing the Defense Contract Audit Agency's (DCAA) services to review policies and procedures as well as, test transactions of NASA's significant contractors,

- Developed new policies and procedures to be fully implemented during FY 2005,
- Amended certain major contracts to require monthly reporting of property values, and
- Provided training to its contractors on a variety of topics germane to the audit issues identified in prior year audit reports and its own analysis and observations of several contractor locations.

NASA's approach to recognizing and accounting for fixed assets is heavily dependent on activities at its contractors, and subsequent reviews to determine amounts which should be capitalized. Currently, NASA expenses all costs and then performs a review of the transactions to determine which costs should be capitalized. The subsequent review and dependence on contractor reporting increases the risk that costs will not be properly capitalized. Until NASA successfully implements a single integrated system for reporting property, and develops a methodology to identify costs that need to be capitalized as the transaction is processed, the Agency will continue to experience difficulties in recording these transactions. Additionally, further emphasis on processes at the contractor locations, the Centers and Headquarters is needed to ensure that amounts reported in its financial statements are reliable.

During our testing, we noted significant weaknesses in the property area. The weaknesses we noted during FY 2004, most of which are consistent with last year's audit report, relate primarily to insufficient internal controls surrounding contractor-held PPE, materials and NASA-held theme assets and NASA-held work in progress (WIP). For example:

- The FY 2003 audit report recommended that NASA require contractors to create plans to resolve their respective deficiencies and NASA establish internal controls and policies and procedures to ensure the plans are created and carried out. In FY 2004, NASA established a quality assurance program, using the DCAA's services to review policies and procedures as well as test transactions of NASA's significant contractors. One component of DCAA's work is to review previous year's findings, including contractors' progress with resolution of deficiencies. We reviewed the results of DCAA's reviews and found that for the majority of the contractors visited, there does appear to have been improvement in the contractor's attempts to address and correct deficiencies in FY 2004. We believe, however, that continuous monitoring will be required to ensure further improvement is noted.
- Consistent with the FY 2003 recommendations, NASA should ensure that all of its contractors have formal policies and procedures to detect and correct errors reported on the NASA Form (NF) 1018. Additionally, it was recommended that NASA require its contractors to review PPE and Materials reported by subcontractors on NF 1018 before submitting the information to NASA. Within its new quality assurance program, DCAA's review program requires a determination as to whether or not the contractors have formal policies and procedures to detect and correct errors; and whether or not the contractor is performing validation of its subcontractor data. As a result of applying their procedures to the March 31, 2004 quarterly report, DCAA identified an error of approximately \$300 million in the computation of WIP. Since the error was not detected

by the contractor's review process nor was it detected by the validation procedures performed by the NASA property branch, policies and procedures may not have been fully implemented.

- In FY 2003 the prior year auditors recommended that NASA transition its Corrective Action Plan into an annual "Audit Plan" that establishes annual objectives pertinent to the Agency's specific PPE and materials internal control and financial statement reporting goals. In FY 2004, NASA developed a matrix which identifies the high, medium and low risk contractors. The matrix was populated with such elements as significant findings and internal control deficiencies and significant amounts of property holdings. High risk contractors are scheduled to be reviewed every year, while medium and low risk contractors will be reviewed on a rotating basis at regular intervals. Based on the results of the DCAA's procedures, the development of a matrix to identify high, medium and low risk contractors was a beneficial process. Given the fact that the DCAA procedures were performed for most contractors as of March 31, 2004, this control only applied to the first six months of the year. NASA needs to continue to further refine the process in order that DCAA perform the agreed-upon procedures for the high risk contractors as close to September 30 as possible. This would provide additional assurance that any possible large errors that had not been detected by controls at the contractor or through the validation procedures performed by NASA personnel would be identified in order that the corrections could be made in a timely manner for the preparation of the annual financial statements. Finally, it is suggested that NASA re-evaluate each contractor annually for purposes of classifying it as a high risk, medium risk or low risk contractor.
- The FY 2003 audit report recommends that the development and update of policies and procedures related to property occur and training be provided to the appropriate parties to ensure an understanding of current requirements. On September 30, 2004, NASA management completed its update to its policies and procedures manual; however, because it was not completed until year-end, any effects to accounting and reporting of property would not be observed until FY 2005. Because of the new training manual and the expected implementation of the Contractor Held Asset Tracking Software (CHATS) to facilitate its contractor reporting process in FY 2005, annual training of personnel will continue to be essential to update the NASA contractor representatives, NASA property accountants, and property administrators on property-related requirements.
- During FY 2003, it was recommended that NASA further modify the NF 1018 reporting process for the remaining contractors to report on a quarterly basis. The contractual requirement for monthly reporting by contractors with anticipated property balances in excess of \$10 million in property should allow for more timely and accurate reporting by the contractors. In FY 2004, NASA developed and implemented an estimation methodology in regard to categories of contractor held property. This methodology was designed to estimate the change in contractor held property for the period from June 30, 2004 to September 30, 2004, and to be used as a method to record the balances as of September 30, 2004 for most of the contractor held property. The estimates were revised, as appropriate, based on additional feedback from certain of the large contractors. However, certain calculations in the estimation process were dependent upon information

provided by the contractors for the nine-month period ended June 30, 2003 and the nine-month period ended June 30, 2004—neither period which had been validated under the new quality assurance process.

- For FY 2005, NASA should further evaluate the estimation process to determine if the contractor held property balances can be subjected to certain agreed-upon procedures to be performed by DCAA much later in the fiscal year. In addition, as a result of the monthly reporting by the large contractors and the new CHATS project, we also suggest that NASA further analyze whether the estimation process should be continued in future years or are there other options available to utilize current data from the contractors as a result of the monthly reporting by large contractors and any new information available as a result of the CHATS implementation.
- As originally recommended last year, NASA should continue to ensure compliance with its documentation requirements by monitoring its contractors through management reviews and inspection visits. Additionally, NASA should continue to require complete supporting documentation for all PPE and Materials transactions, specifically for asset transfers. Finally, NASA should create a reconciliation process to reconcile all of its asset transfers on a quarterly basis and include within that process formal confirmations between the issuing contractor and the receiving contractor.

Beginning in FY 2004, as part of its new quality assurance program, an ongoing portion of DCAA's work is to validate that selected transfers are properly documented and recorded. One of the procedures that DCAA performs as a part of its engagement is to send a confirmation to the sending/receiving party with regard to the specific transfer in/transfer out transaction that is being tested to insure the proper recording of the transfer as well as to establish that both parties of the transaction have made the proper entry on a timely basis.

- In addition, a component of NASA Headquarter's validation process of contractors' quarterly property reports is to review the documentation of significant transfers and to ensure that the transfer is reconciled between the two contractors. However, as a result of the significant number of transfers between and among contractors, we recommend that NASA continue to explore the possibility of creating a process to reconcile all of its asset transfers on a monthly/quarterly basis with a formal confirmation process between the issuing contractor and the receiving contractor.
- The FY 2003 audit report recommended that NASA create formal policies and procedures to ensure all appropriate costs are capitalized as part of NASA theme assets (formerly NASA held assets in space) and NASA-held WIP accounts. In addition, it recommended the development of formal cost allocation policies for theme assets, including specificity of what costs are required to be capitalized and what costs should be expensed. Additionally, NASA management should enhance its theme assets policy to specifically include what costs should be capitalized/expensed, including a uniform list of cost identifiers (e.g., Unique Project Numbers [UPNs]) that support each of those assets to ensure its policy is consistently applied and that a sufficient audit trail exists documenting management's assertions surrounding the value of each asset.

In FY 2004, NASA undertook a project to review its policies (both accounting and procedural) with respect to theme assets (previously referred to as assets in space) to identify the specific costs that should be capitalized and those that should be expensed. This policy incorporated financial and engineering authoritative guidance, as well as NASA program/project management policy to ensure the consistent application and documentation. However, due to the uniqueness of these assets, management has deferred implementation of this policy until NASA has (1) coordinated this approach with other agencies with similar assets, and (2) presented the approach to the Federal Accounting Standards Advisory Board, in order to ensure all federal requirements are fully implemented.

Recommendation

We recommend that NASA continue to focus on resolving prior year issues and completing its implementation of suggested recommendations and corrective action plans. In addition, we recommend that NASA fundamentally revisit its approach to capitalizing property. We also recommend that all NASA obligation documents and expenditures be coded to identify whether they relate to a property acquisition. Outlays so calculated would create a control for comparison to recorded property transactions and subsidy ledgers, be they NASA activities or contractors.

Improvements in the IFMP Control Environment Are Needed (Modified Repeat Condition)

As discussed above, over the last several years NASA has been migrating its accounting and financial management systems to a new system and processing environment intended, upon full implementation, to provide a comprehensive entity wide resource planning (ERP-SAP within NASA) system. Our assessment of the IFMP computing environment that supports NASA's significant financial applications indicated that several improvements are needed to strengthen the design and operating effectiveness of the Agency's information security program.

Weaknesses were identified at NASA in three control areas:

- Access Controls
- Systems Software
- Segregation of Duties

Access controls. When properly implemented, access controls can help ensure that critical systems assets are physically safeguarded and that logical access to sensitive computer programs and data is granted to users only when authorized and appropriate. Access controls over computer operating systems and data communications software are also closely related. Weaknesses in such controls can compromise the integrity of sensitive Agency data and increase the risk that such data may be inappropriately used and/or disclosed.

Access control weaknesses continue to be identified and represent a significant risk to the IFMP program. Procedures were not consistently followed for monitoring unused IDs, locked IDs, or access re-certifications. User accounts were not deactivated after several consecutive failed login attempts and auditing was not set up to help investigate failed attempts. The use of the Password Wizard for generating initial passwords, the use of complex passwords, and the change of user passwords at regular intervals were not enforced on certain systems across the Agency. Users were also not prohibited from selecting previously used passwords. In addition, a significant number of users had access to sensitive SAP transaction codes and authorizations, files, and queries. Changes to SAP user security profiles that were made to allow temporary powerful access to the production environment were not appropriately documented.

During penetration vulnerability testing at the Marshall Space Flight Center, weaknesses were identified related to user account and password management, Internet security, and systems software configuration. These weaknesses were identified in peripheral infrastructure systems critical to SAP.

Systems software. Systems software represents computer programs designed to operate and control the processing activities of computer hardware and related equipment. Systems software helps coordinate the input, processing, output, and data storage associated with all of the applications that are processed on a specific system. Weaknesses in such controls can compromise the integrity of sensitive Agency data and increase the risk that such data may be inappropriately used and/or disclosed.

System software weaknesses continue to be identified and represent a significant risk to the IFMP program. Testing of changes to system software was not always documented. Unnecessary services were enabled and access to sensitive system software utilities and system and object privileges were not appropriately controlled. Operating systems were not always updated to incorporate the latest available system fixes and security upgrades. In addition, system files were not adequately protected by file permissions and the Agency was unable to provide evidence of audit log reviews.

Segregation of Duties. Segregation of duties controls provide policies, procedures, and an organizational structure to prevent one or more individuals from controlling key aspects of computer-related operations and thereby conducting unauthorized actions or gaining unauthorized access to assets or records. Segregation of duties weaknesses continues to be identified and represent a significant risk to the IFMP program. We were informed that in order to correct errors attributed by NASA to weaknesses within the SAP industry solution used by NASA, a significant number of SAP application support personnel were given access to the development and production environments. This access enabled these individuals to potentially make unauthorized changes to the production environment and potentially be involved in the direct processing of accounting transactions. Also, additional competency center staff were occasionally granted additional roles to make changes directly in the production environment. Although we were informed that the competency center monitors all changes made to production data through its change management system, there is a risk that changes could be made to production data that bypass these change management and monitoring controls.

The level of risk associated with the matters noted depends in part upon the extent to which compensating controls (such as reconciliations and robust reviews of output) are in place and operating effectively during the audit period. Certain of these controls designed to detect errors or inappropriate processing may also not be executed in a manner which can be expected to identify errors which, while perhaps not material to the financial statements as a whole, may subject NASA to the risks regarding safeguarding of assets. Within the context of the overall ineffective control environment referenced in the accompanying comments, the information technology related issues discussed above merit management focus.

Recommendation

NASA should implement controls to address deficiencies in access controls, systems software controls, and segregation of duties to include:

- Monitoring and reviewing the activities of users with powerful access privileges and eventually segregating such production access and ability to create accounting transactions from the development function.
- Consistently following procedures related to user account management.
- Implementing stronger password controls and restricting user access to programs and data to the minimum level required by the user's responsibilities.
- Disabling unnecessary system software services, restricting access to sensitive software utilities, and updating operating systems in a timely manner.

REPORTABLE CONDITION

Internal Controls in Estimating NASA's Environmental Liability Require Enhancement

During our review of NASA's environmental liability estimates totaling \$986 million as of September 30, 2004, and related disclosures to the financial statements, we noted weaknesses in NASA's ability to generate an auditable estimate of its environmental unfunded liabilities and to identify disclosure items because of a lack of sufficient, auditable evidence. In general, we noted the following:

- NASA's Accounting, Environmental and Legal functions' roles and responsibilities for the estimation of the unfunded environmental liability are not sufficiently defined to ensure appropriate integration and input into the process. NASA's accounting function defers to the environmental practice in preparation of the estimates, resulting in environmental professionals interpreting accounting requirements.
- As of September 2004, NASA personnel and its contractors had not received sufficient policies, procedures and training in the process for estimating environmental liabilities. Although NASA released in June 2004 an environmental cost restoration handbook to

provide guidance to the NASA centers, the handbook was not adequately detailed to support a reliable estimate.

- NASA did not have adequate, auditable documentation to support its 2004 environmental liability estimates.
- NASA does not have documented quality control or quality assurance procedures to ensure the accuracy of the unfunded environmental liability estimates.

Roles and Responsibilities Need Further Refinement

During our testing of the unfunded environmental liability estimates, we were informed that NASA's environmental professionals prepared the estimates without direction or oversight from the Office of the CFO. Specifically, we were advised that the Office of the CFO deferred to NASA's Environmental Management Division (EMD) as experts in the preparation of the estimates. As a result of this division of responsibility, NASA's EMD made interpretations of federal accounting requirements in isolation without input and oversight from the CFO's office. We also noted that the CFO's office and NASA Legal Counsel were not interacting with the Department of Justice attorneys who were managing third-party claims on behalf of NASA in a manner that would allow NASA to recognize those liabilities when they are probable and estimable, in accordance with guidance provided in "*Interpretation of Federal Financial Accounting Standards Interpretation No. 2, Accounting for Treasury Judgment Fund Transactions, an interpretation of Statement of Federal Financial Accounting Standards (SFFAS) No. 4 and No. 5.*"

Increased Guidance and Training Required

The preparation of NASA's unfunded environmental liability estimates requires an understanding of environmental cost estimating and related accounting guidance. During the audit, NASA indicated that its Remedial Project Managers lacked sufficient environmental cost estimating experience to adequately prepare the estimates. To mitigate this deficiency, NASA is implementing the use of the Integrated Data Evaluation and Analysis Library (IDEAL) cost-estimating software. IDEAL generates estimates through the use of parametric cost models. However, based on our review, the users did not have a sufficient understanding of how the IDEAL system worked. This was evidenced by their questions about the software and the correction of prior year estimates.

NASA's environmental personnel received minimal accounting guidance and training. This lack of guidance and training resulted in several findings including: estimating liabilities in a manner that was inconsistent with accounting guidance on "probable" and "reasonably estimable"; inadequate quantification, categorization and tracking of changes in the year-to-year estimation process; lack of quantification and disclosure of "possible" environmental liabilities for financial statement purposes; improper presentation of a range of environmental estimates in financial statements; and improperly accruing for environmental liabilities associated with NASA-owned tanks and landfills.

NASA recently issued guidance in June 2004; however, not all centers/facilities were familiar with the guidance on probable and reasonable, and estimable determinations contained within this document.

Documentation to Support Liability Need Improvements

NASA did not consistently document the assumptions it used to prepare its unfunded environmental liability estimates. During our audit testing, NASA's environmental personnel often could not explain or provide documentation as to how, or why, they selected a specific estimate at several of its centers/facilities. Also, during the audit we were told that there was limited sharing of experiences/information between centers/facilities to ensure that similar liabilities at different locations were estimated consistently within NASA.

Insufficient Quality Control over Center Estimates

During the audit we could not find evidence to support that NASA performed an independent quality review of the unfunded environmental liability estimates prepared by the centers/facilities. While NASA's environmental personnel at Headquarters did perform a review of the estimates, we observed errors that may have been identified had a more formal review occurred. For example, we noted the inclusion of certain costs associated with funded liabilities and installed equipment in the unfunded environmental liability estimates.

We also observed that the organizational structure described earlier allowed the Environmental personnel to make accounting decisions without oversight from the Office of the CFO. This included using a higher end estimate, when no point in the range is better than any other. NASA environmental personnel described this use of "higher-end" estimates as being "conservative." This is not consistent with Federal Financial Accounting and Auditing Technical Release Number 2.

Finally, we believe it is important that the IDEAL model be periodically reconciled with actual spending to validate the model. Currently, IDEAL has not been validated and accredited for estimating NASA remediation scenarios in accordance with OMB and NASA guidelines. NASA indicated that some models within IDEAL were evaluated under a Department of Defense (DOD) contract. However, a review by the DOD's Office of Inspector General indicated similar concerns regarding validation of the model.

Recommendation

We recommend that NASA document the process that it uses to prepare its unfunded environmental liability estimates. After the process is outlined, NASA should perform an analysis to help ensure the proper NASA personnel are participating. The analysis should help identify who in the process has responsibility and authority and who should be consulted and informed for each step. The benefit of this approach is that it would allow the CFO's office to

determine the level of organizational integration among departments and where in the process input from the CFO's office is needed.

NASA has numerous policies, procedures and reports. To support the centers/facilities in the preparation of these estimates, NASA should conduct a gap analysis for each step of the newly outlined process to determine where there is conflicting or inadequate information or training. NASA should then develop an "evergreen" document of the current policies, procedures, guidance and training that is available in preparation of the estimate. This should be reviewed at an annual training conference.

NASA should also validate the tools (including IDEAL) and methodology used at the center/facility level to prepare the unfunded, environmental liability estimates.

OTHER MATTERS

Summary of FY2003 Material Weaknesses and Reportable Conditions

Issue Area	Summary Control Issue	FY 2004 Status
Material Weaknesses:		
NASA lacks sufficient audit trail to support that its FY 2003 Financial Statements are presented fairly	Documentation regarding significant accounting events, recording of non-routine transactions and post closing adjustments, as well as correction and other adjustments made in connection with data conversion issues must be strengthened	Modified Repeat Condition
NASA lacks effective Internal Controls surrounding its Fund Balance with Treasury Reconciliations	Supporting documentation to support application of rigorous reconciliation processes was not available. Unreconciled differences were identified in the FY 2003 year-end reconciliations	Modified Repeat Condition
NASA processes for preparing its Financial Statements still require improvement	Processes to prepare financial statements were not executed in a sufficiently timely and rigorous manner to support meeting reporting deadlines established by OMB	Modified Repeat Condition

Issue Area	Summary Control Issue	FY 2004 Status
<u>Material Weaknesses:</u>		
NASA still lacks adequate controls to reasonably assure that Property, Plant and Equipment and Materials are presented fairly in the Financial Statements	Controls relating principally to contractor-held PPE and materials and NASA-held Assets in Space and WIP need improvement; headquarters oversight needs improvement	Modified Repeat Condition
<u>Reportable Conditions:</u>		
Security Controls in NASA's Financial Statements Environment need improvement	IFMP Security Design and Implementation needs improvement, IFMP Security and General IT controls need to be strengthened, Oversight function supporting IFMP Security program needs improvement	Modified Repeat Condition, classified as material weakness in FY 2004 due in part to segregation of duties issues and interaction with weaknesses in financial management control processes

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In addition, with respect to NASA's internal control over Required Supplementary Stewardship Information (RSSI) and performance measures reported in the Management, Discussion and Analysis, we were unable to apply certain procedures prescribed by OMB Bulletin No. 01-02, because of the limitations on the scope of the audit of the financial statements, as discussed in our Report of Independent Auditors, dated October 29, 2004. Further, we did not audit and do not express an opinion on such controls.

We also noted certain other matters involving internal controls that we will report to NASA management in a separate letter dated October 29, 2004.

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

Ernst + Young LLP

October 29, 2004
Washington, D.C.

Report on Compliance with Laws and Regulations

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

We were engaged to audit the consolidated financial statements of the National Aeronautics and Space Administration (NASA) as of September 30, 2004, and have issued our report thereon dated October 29, 2004. The report states that because of the matters discussed therein, 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 as of September 30, 2004, and the related consolidated statement of net costs, statements of changes in net position and financing, and combined statement of budgetary resources for the fiscal year then ended.

The management of NASA is responsible for complying with laws and regulations applicable to NASA. 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 Office of Management and Budget (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 NASA's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements. However, as noted above, we were unable to complete our audit. Based upon the results of the tests we were able to complete, we noted certain instances, described below, in which NASA's financial management systems did not substantially comply with certain requirements:

- The NASA accounting system lacks integration and does not conform to the requirements currently specified by the Joint Financial Management Improvement Program. As identified in Footnote Sixteen to the financial statements, NASA's management continues to identify data integrity and configuration issues in the Core Financial system which results in inappropriate transactional postings. Additionally, the core financial system is unable to provide detailed listings of balances to support NASA's September 30, 2004, reported balances for accounts receivable, accounts payable and undelivered orders. Finally, certain subsidiary systems, including property, are not integrated with the Core Financial system.

Report on Compliance with Laws and Regulations

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- Issues with the Core Financial System continue to hinder NASA's ability to identify and resolve certain issues with its Fund Balance with Treasury amounts.
- Data within NASA's financial system have not been validated as reliable and may not be reliable to support NASA's financial statements.
- Weaknesses identified in NASA's financial management systems' access and application controls are significant departures from requirements specified in OMB Circulars A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*.
- Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, SFFAS No. 4, *Managerial Cost Accounting Concepts & Standards*, and NASA's Financial Management Requirements, require costs to be accrued in the period in which they are incurred and any corresponding liability to be recorded as an account payable, regardless of the associated amounts obligated. However, NASA has designed its new Core Financial Module to include a system edit whereby if costs (and the corresponding liabilities) are greater than the associated obligations, the difference is not recorded in NASA's general ledger until further research is performed. Instead, these differences are stored outside of its general ledger until additional funds are obligated and the excess costs (and the corresponding liabilities) can be recorded. Similarly, the Core Financial Module will not allow negative costs or downward adjustments to be recorded in the general ledger. We believe that NASA's accounting treatment of costs in excess of obligations and downward adjustments during fiscal years 2003 and 2004 represent noncompliance with the Federal accounting standards requirements and SGL requirements under FFMIA.

The Report on Internal Control includes information related to the financial management systems that were found not to comply with the requirements, relevant facts pertaining to the noncompliance, and our recommendations related to the specific issues presented. It is our understanding that management agrees with the facts as presented, and that relevant comments from the NASA's management responsible for addressing the noncompliance are provided as an attachment to this report.

Additionally, NASA has informed OMB of the status of its implementation of the Improper Payment Information Act of 2002 (IPIA). In its risk assessment, NASA identified and tested those payments related to firm-fixed price contracts from each of the Centers. Although the IPIA discusses consideration of other types of payments, NASA did not explicitly consider these payments as part of the risk assessment process or prepare an estimate of improper payments, but did note that audit efforts by nonfederal auditors with respect to grantees and by government auditors with respect to certain NASA contracts aid in identifying and mitigating improper payments. As of September 30, 2004, NASA may not have fully complied with the IPIA requirements.

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Because we could not complete our audit, we were unable to determine whether there were other instances of noncompliance with laws and regulations that are required to be reported.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

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

Ernst + Young LLP

October 29, 2004
Washington, D.C.