



UNITED STATES
NUCLEAR REGULATORY COMMISSION
WASHINGTON, D.C. 20555-0001

November 9, 2007

OFFICE OF THE
INSPECTOR GENERAL

MEMORANDUM TO: Chairman Klein

FROM:

A handwritten signature in cursive script, appearing to read "Hubert T. Bell".

Hubert T. Bell
Inspector General

SUBJECT: RESULTS OF THE AUDIT OF THE UNITED STATES
NUCLEAR REGULATORY COMMISSION'S FINANCIAL
STATEMENTS FOR FISCAL YEARS 2007 AND 2006
(OIG-08-A-01)

The Chief Financial Officers Act of 1990, as amended, (CFO Act) requires the Inspector General (IG) or an independent external auditor, as determined by the IG, to annually audit the United States Nuclear Regulatory Commission's (NRC) financial statements in accordance with applicable standards. In compliance with this requirement, this memorandum transmits the following R. Navarro & Associates, Inc. Auditors' Reports:

- Independent Auditors' Report on the Financial Statements,
- Independent Auditors' Report on the Effectiveness of Internal Control over Financial Reporting, and
- Report on Compliance with Laws and Regulations.

Objective of a Financial Statement Audit

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

R. Navarro & Associates' examination was made in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. The audit included obtaining an understanding of the internal controls over financial reporting and testing and evaluating

the design and operating effectiveness of the internal controls. Because of inherent limitations in any internal control, there is a risk that errors or fraud may occur and not be detected. Also, projections of an evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

Results of Audit

The results are as follows:

Financial Statements

- FYs 2007 and 2006 - Unqualified opinion

FY 2007 Internal Controls

- Qualified opinion
- Significant Deficiencies:
 - Information Systems Security Controls (Continuing Material Weakness)
 - Fee Billing System (Significant Deficiency)

FY 2007 Compliance with Laws and Regulations

- Substantial Noncompliance:
 - Information Systems Security Controls

OIG Oversight of R. Navarro & Associates, Inc. Performance

To fulfill our responsibilities under the CFO Act and related legislation for ensuring the quality of the audit work performed, we monitored R. Navarro & Associates' audit of NRC's FYs 2007 and 2006 financial statements by:

- Reviewing their approach and planning of the audit,
- Evaluating the qualifications and independence of its auditors,
- Monitoring the progress of the audit at key points,
- Examining the working papers related to planning and performing the audit and assessing NRC's internal control,

- Reviewing R. Navarro & Associates' audit reports to ensure compliance with *Government Auditing Standards* and OMB Bulletin No. 07-04,
- Coordinating the issuance of the audit reports, and
- Performing other procedures that we deemed necessary.

R. Navarro & Associates, Inc. is responsible for the attached auditors' reports, dated November 7, 2007, and the conclusions expressed therein. The Office of the Inspector General (OIG) is responsible for technical and administrative oversight regarding the firm's performance under the terms of the contract. Our review, as differentiated from an audit in conformance with *Government Auditing Standards*, was not intended to enable us to express, and accordingly we do not express, an opinion on:

- NRC's financial statements,
- The effectiveness of NRC's internal control over financial reporting, or
- NRC's compliance with laws and regulations.

However, our monitoring review, as described above, disclosed no instances where R. Navarro & Associates, Inc. did not comply with applicable auditing standards.

Performance Reporting

As required by OMB Bulletin No. 07-04, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we:

- Obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, and
- Determined whether they have been placed in operation.

Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

Meeting with the Chief Financial Officer

At the exit conference on November 7, 2007, representatives of the Office of the Chief Financial Officer, OIG, and R. Navarro & Associates, Inc. discussed the issues in the report related to the results of the audit.

Comments of the Chief Financial Officer

In his response, the CFO agreed with the auditors' recommendations. We will follow-up on the CFO's implementation of planned corrective actions during FY 2008. The full text of the CFO's response follows this report.

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

Attachments: As stated

cc: Commissioner Jaczko
Commissioner Lyons

Chairman Dale E. Klein
U.S. Nuclear Regulatory Commission
Washington, DC

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

- the financial statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America;
- NRC had effective internal control over financial reporting except for the effects of a material weakness related to information systems security controls;
- no instances of noncompliance with laws and regulations, exclusive of the Federal Financial Management Improvement Act (FFMIA), that are required to be reported under applicable audit standards; and
- one instance of substantial noncompliance with the requirements of FFMIA related to information systems security controls.

The following sections provide additional detail about our conclusions and the scope of our audits.

INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of NRC as of September 30, 2007, and 2006, and the related statements of net cost, statements of changes in net position, and statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of NRC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. Those standards and the Bulletin require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis,

evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Matters of Emphasis

Classification of Costs

OMB Circular A-136, *Financial Reporting Requirements*, provides guidance to Federal agencies for presenting program costs classified by intragovernmental and public components. The basis for classification relies on the concept of who received the benefits of the costs incurred (i.e., private sector licensees versus Federal licensees) rather than who was paid. However, following the advice of OMB, NRC classified the costs on the Statements of Net Cost using an underlying concept of who was paid. Furthermore, OMB Circular A-136 requires that the Statement of Net Cost be presented using full program costs by output. NRC presents its costs aggregated by strategic plan programs.

U.S. Department of Energy Expenses

NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. For the fiscal years ended September 30, 2007, and 2006, NRC's Statements of Net Cost include approximately \$64.4 and \$67.8 million, respectively, of reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations applicable to NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the Government Accountability Office's (GAO) Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and provide the results of its audits to NRC.

Opinion

In our opinion, the financial statements referred to above and included in NRC's Performance and Accountability Report present fairly, in all material respects, the financial position of NRC as of September 30, 2007, and 2006, and its net costs, changes in net position, and budgetary resources for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 14 to the financial statements, NRC changed its presentation of allocation transfers as required by OMB Circular A-136.

INDEPENDENT AUDITORS' REPORT ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

We have examined the effectiveness of NRC's internal control over financial reporting, as of September 30, 2007, based on the criteria in OMB Bulletin No. 07-04. The Bulletin states management is required to establish internal accounting and administrative controls to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and that assets be safeguarded against loss from unauthorized acquisition, use or disposal. NRC's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control over financial reporting based on our examination.

Our examination was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants (AICPA); the standards applicable to financial statement audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Accordingly, we obtained an understanding of the internal control over financial reporting, tested and evaluated the design and operating effectiveness of internal control, and performed such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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

We noted certain matters involving the internal control and its operation that we consider to be significant deficiencies under standards established by the AICPA and OMB Bulletin No. 07-04. A significant deficiency is a deficiency in internal control, or combination of deficiencies, that adversely affects an entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of an entity's financial statements that is more than inconsequential will not be prevented or detected. As discussed further in this report, the significant deficiencies are related to: (1) weaknesses in NRC's information systems security controls, and (2) weaknesses in NRC's fee billing system.

As defined by OMB Bulletin No. 07-04, a material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. The significant deficiency related to information systems security controls is considered to be a material weakness.

In our opinion, except for the effect of the material weakness described below, NRC has maintained, in all material respects, effective internal control over financial reporting as of September 30, 2007, based on the internal control objectives listed in OMB Bulletin No. 07-04.

Information Systems Security Controls

The Federal Information Security Management Act (FISMA) independent evaluations for fiscal years 2005 and 2006 identified several weaknesses in NRC's information systems security program. The fiscal year 2007 evaluation (Report OIG-07-A-19) identified similar results, including 14 weaknesses of which the following two were considered to be significant deficiencies:

- “Only 2 of the 30 operational NRC information systems have a current certification and accreditation, and only 4 of 11 systems used or operated by a contractor or other organization on behalf of NRC have a current certification and accreditation.... [and]
- Annual contingency testing is still not being performed for all systems.”

Based on a self-evaluation of management controls over information systems, NRC concluded that the two significant deficiencies identified in the FISMA report should be reported as a material weakness in its annual statement of assurance required by the Federal Managers' Financial Integrity Act (FMFIA).

Certification and Accreditation

The primary financial management systems consist of three NRC operated systems and two systems operated by the Department of Interior's National Business Center. Of these five systems, three had current certifications and accreditations as of September 30, 2007. The other two operated under interim authorities to operate (IATO) during the entire year. An IATO is a limited authorization to operate an information system under specific terms and conditions and acknowledges greater agency-level risk for a limited period of time. An information system is not considered accredited during the period of limited authority to operate.

Furthermore, although some of the financial management systems have current certifications and accreditations, all financial management systems were and are at risk because they either reside on or rely on a general support system (GSS) which does not have a current certification and accreditation. Therefore, management does not know whether the security controls for the general support systems are adequate, thereby creating potential risk. All NRC information systems that depend on the security controls provided by the general support systems inherit that potential risk.

OMB Circular A-130, *Management of Federal Resources*, Appendix III, characterizes the absence of authorization to process (certification and accreditation) as an example of a significant deficiency.

Annual Contingency Testing

During fiscal year 2007, annual contingency plan testing was performed for all of the primary financial management systems, however, testing was not performed for 25 of the remaining NRC information systems, including a GSS, and 9 of the remaining contractor operated systems. Contingency plan testing is considered to be a key element of information system security programs, and is essential in determining whether or not plans will function as intended in an emergency situation.

Recommendation

1. The CFO should coordinate with the Office of Information Services and the Executive Director for Operations to ensure that any vulnerabilities of the general support systems and the financial management systems are addressed and resolved timely.

OMB Bulletin 07-04 requires significant deficiencies identified in the FISMA evaluation that are related to financial management systems be reported as a substantial noncompliance with FFMIA. Accordingly, our report on compliance with laws and regulations identifies the FISMA significant deficiencies previously described as a substantial noncompliance with FFMIA, because three systems did not have a current certification and accreditation, and contingency plan testing was not performed for a GSS.

Fee Billing System

NRC is required by law to recover a percentage of its budget authority in each year through fees billed to reactor and materials licensees and applicants. Annual license fees are assessed under 10 CFR Part 171 for nuclear facilities and materials licensees. Other fee types include licensing actions, inspections and other services, established in 10 CFR Part 170. Since fiscal year 2004, we have reported a material weakness related to NRC's fee billing system. The deficiencies reported included: (1) intensive manual processes, (2) the lack of comprehensive quality assurance procedures over the billing process, and (3) the fee billing feeder processes.

The following paragraphs describe the conditions and the agency's progress in addressing them.

- **Intensive Manual Processes.** Due to the age and design of the Fee Billing System, NRC has evolved an operating style characterized by over-reliance on a small team to prepare, review, and issue billings on a monthly and quarterly basis. The system does not easily provide a drill down capacity to review billing questions.
- **Comprehensive Quality Assurance Procedures.** NRC's existing quality assurance procedures do not fully address the completeness of billable hours.

- **Fee Billing Feeder Processes.** In prior years, NRC has identified significant underbillings due to various deficiencies of feeder processes, and a lack of independent checks to validate the completeness of feeder data.

The above conditions continue to affect the fee billing process. However, as discussed below, during fiscal year 2007, NRC took various steps to improve its internal control over the billing cycle.

In February 2007, NRC revised its standard procedures for the Part 170 quarterly certification process used by Headquarters and regional offices. The procedures were revised based on consultations with fee coordinators and an analysis of prior underbilling cases, and were designed to improve the accuracy of the quarterly billings. These procedures were applied to the third and fourth quarter of FY 2007.

NRC also developed a validation application to compare hours recorded in HRMS, the time and labor system, to the hours billed under Part 170. The application was used as a compensating control to validate billings issued for inspections, licensing actions and other billable tasks for the entire fiscal year. This effort resulted in identifying underbillings of approximately \$2.6 million that had not been detected by employees in the normal course of performing their assigned billing duties. These results illustrate the need for the continued and expanded application of detection controls to compensate for deficiencies inherent in the current billing process. Further, although the application was used to validate most billings for the entire fiscal year, it was not performed on an ongoing routine basis throughout the entire fiscal year. Finally, we noted that the validation application has not been applied to casework fees.

In fiscal year 2007, we noted that the Part 170 fees receivable of \$26 million related to inspections in process at year end were initially understated by \$4.7 million because existing controls did not detect that the quarterly “future billables” reports only reflect unbilled hours incurred during a given quarter. At our request, management adjusted the accounts receivable reported in the accompanying financial statements to appropriately reflect all unbilled hours at year end.

While many improvements were made to the fee billing processes in FY 2007, we conclude that the remaining weaknesses constitute a significant deficiency as defined by OMB. However, this finding is no longer considered to be a material weakness.

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

Recommendation

2. The CFO should continue to define, design, and implement compensating controls over the fee billing system.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We conducted our audit for the year ended September 30, 2007, in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Bulletin No. 07-04.

NRC management is responsible for complying with laws and regulations applicable to NRC. As part of obtaining reasonable assurance about whether NRC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of applicable regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 07-04, including FFMIA requirements. We limited our tests of compliance to those provisions and we did not test compliance with all laws and regulations applicable to NRC. The objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions of laws and regulations and, accordingly, we do not express such an opinion.

U.S. Department of Energy Expenses

NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. For the fiscal years ended September 30, 2007, and 2006, NRC's Statements of Net Cost include approximately \$64.4 and \$67.8 million, respectively, of reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations applicable to NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the GAO's Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and should provide the results of its audits to NRC.

The results of our tests of compliance with laws and regulations, exclusive of those referred to for FFMIA, disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04.

Under FFMIA, we are required to report whether NRC'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 the provisions of FFMIA section 803(a). The results of our tests disclosed one instance, noted below, where NRC's financial management systems did not substantially comply with Federal financial management systems requirements.

In our *Report on the Effectiveness of Internal Control Over Financial Reporting*, we identified a material weakness in NRC's information systems security controls. We believe that this matter represents substantial noncompliance with the Federal financial management system requirements under FFMIA.

Status of Prior Year Comments

In our prior year report on internal control, we discussed the presence of material weaknesses related to the fee billing system and information systems security controls. During fiscal year 2007, NRC improved its internal control over fee billings by implementing additional detection controls. Consequently, we conclude that the remaining weaknesses in the fee billing system constitute a significant deficiency, as defined by OMB, but the significant deficiency is not considered to be a material weakness. The material weakness related to the information systems security controls continued to exist during fiscal year 2007.

In our prior year report on compliance with laws and regulations we reported a noncompliance related to the development of Part 170 fees and a substantial noncompliance with FFMIA related to the Fee Billing System. Corrective actions have been implemented by NRC to remediate the Part 170 fees noncompliance and that prior finding is now closed. Furthermore, due to certain compensating controls implemented by management in FY 2007, we determined that the remaining weaknesses in the Fee Billing System do not represent substantial noncompliance with FFMIA.

INTERNAL CONTROL RELATED TO PERFORMANCE MEASURES

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

CONSISTENCY OF OTHER INFORMATION

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information referred to as the Management Discussion and Analysis, Chapter 1 of this Performance and Accountability Report, is not a required part of the financial statements but is supplementary information required by OMB Circular A-136. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

The other accompanying information included in Chapter 2 and the appendices to the Performance and Accountability Report, is required by OMB Circular A-136 and is presented for purposes of additional analysis and is not a required part of the financial statements. Such

information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information, Schedule of Budgetary Resources, included in the Performance and Accountability Report, is not a required part of the financial statements but is supplementary information required by OMB Circular A-136. This information is also presented for purposes of additional analysis. This information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

We noted certain additional matters that we will report to NRC management in a separate letter.

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

R. Navarro & Associates, Inc.

November 7, 2007