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(U) INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

(U) To the Director of the National Reconnaissance Office and the Inspector General of the National Reconnaissance Office:

(U) We have audited the financial statements of the National Reconnaissance Office (NRO) as of and for the year ended September 30, 2015, and we have issued our report thereon dated November 13, 2015. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*.

(U) Internal Control over Financial Reporting

(U) In planning and performing our audit of the financial statements, we considered the NRO's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the NRO's internal control. Accordingly, we do not express an opinion on the effectiveness of the NRO's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 15-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

(U) A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

(U) Our consideration of internal control was for the limited purpose described in the preceding paragraphs and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We identified certain deficiencies in internal control, described in the accompanying Schedule of Findings, that we consider to be significant deficiencies.

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(U) We noted certain additional matters involving internal control over financial reporting that we will report to NRO management in a separate letter.

(U) The NRO's Response to Findings

(U) The NRO's response to the findings identified in our audit is described in a separate memorandum attached to this report. The NRO's response was not subjected to the auditing procedures applied in our audit of the financial statements; accordingly, we do not express an opinion on it.

(U) Purpose of this Report

(U) The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of the NRO's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 15-02 in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in cursive script that reads "Kearney & Company".

Alexandria, Virginia
November 13, 2015

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(U) Schedule of Findings

(U) Significant Deficiencies

I. (U) Significant Deficiency #1 – Cost Classification (Repeat Condition)

(U) The National Reconnaissance Office’s (NRO) Cost Accumulation Policy (CAP) implements guidance to ensure that costs are committed, obligated, incurred, and accumulated in accordance with federal regulations and accounting standards. To ensure compliance with the CAP, the NRO implemented a multi-year, agency-wide initiative to strengthen the overall control environment surrounding cost accumulation and the appropriate accounting classification of transactions associated with Property, Plant, and Equipment (PP&E).

(U) Business Plans and Operations Finance (BPO/FIN) has a variety of maturing controls in place to ensure compliance with the CAP. For example, key controls, which have been in place for several years and continue to be refined and improved, include the Definitized Contract Line Item Number (CLIN) Activity Report (DCAR) and the Contract Modification Activity Report (CMAR). The DCAR and the CMAR controls are designed to assess a Program Office’s selection of expenditure types (ET) and General Ledger Account Codes (GLAC) for each CLIN or subCLIN. While the DCAR centers on the initial assessment to align CLINs to an ET/GLAC, the CMAR focuses on whether the initial CLIN to ET/GLAC alignment remains appropriate based on work activity changes executed through a modification to the contract.

(U) Recently, the NRO established the CAP Compliance Officer (CAPCO) role to strengthen its control environment around cost classification. The CAPCO is responsible for promoting adherence to the NRO’s CAP within Directorates and Offices (Ds and Os). The intended design of the CAPCO adds a preventive internal control to the beginning of the NRO’s acquisition lifecycle to facilitate the accurate future classification of the NRO’s expenditures. While the CAPCO role became effective in fiscal year (FY) 2013, implementation has been ongoing over multiple years and into the fourth quarter of FY 2015.

(U) Kearney & Company, P.C. (Kearney) assessed the NRO’s classification of costs as either period expenses, which are reported as part of Gross Costs, or as capitalized expenditures, which are reported as part of PP&E. While the NRO has made significant progress in its remediation efforts for accurate cost classification, during our testwork, we found the following conditions regarding the accuracy of cost classification and effectiveness of the overall internal control environment:

- ~~(S//REL)~~ The NRO did not properly classify rework costs incurred as part of

[Redacted]

Once we identified the incorrect

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capitalization of costs, the NRO requested early submission of detailed cost information from its contractor, in advance of the November contractual due date, to perform an analysis of costs and determine the amount that should be removed from [redacted]

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- (U) In executing substantive testing procedures over the NRO's classification of costs, Kearney reviewed the Active Contract List (ACL), which is the repository of all ET/GLAC assessments. We considered the adequacy of the NRO's assessment decisions, as documented in the ACL, in regard to providing adequate support to draw a conclusion on the ET/GLAC assessment determination. While it is apparent that the DCAR internal control has matured, evidenced by the thoroughness of recent ET/GLAC assessments documented in the ACL when compared to ET/GLAC assessments documented in previous years, Kearney noted several instances in our testwork where the assessments documented in the ACL did not contain sufficient detail to allow external parties to readily determine the basis on which the assessments were made.
- (U) In addition to our tests over expenditures, Kearney reviewed controls in place around the NRO's monitoring and review of satellite acquisitions. Specifically, we evaluated the

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any adjustments made. During our review of the [redacted] completed for the first three quarters of FY 2015, Kearney noted that three [redacted] contained a total of four variances between the files and the corresponding quarterly general ledger account balances. These variances went uncorrected by both the preparer and the reviewer.

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~~(S//REL)~~ In assessing how to classify the cost accumulation of activity associated with the [redacted] there was a lack of coordinated communication between BPO/FIN and Program Offices regarding how [redacted]

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[redacted] As a result, if the improper classification of rework cost had not been found during the audit, these costs would have been improperly classified on the financial statements.

(U) Though the NRO implemented additional accounting policies and internal controls to improve cost classification, the corrective actions were in process during FY 2015. Specifically, the NRO CAPCO implementation was ongoing, along with continued refinement of acquisition documentation to comply with the CAP. These ongoing initiatives directly impacted the overall effectiveness of the cost accumulation internal control environment and the adequacy of documentation included in the ACL during the year, but there still remains a risk of misstatement for the accuracy of cost classification for NRO expenditures related to assessments made in prior years.

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~~SECRET//REL TO USA, FVEY~~**(U) Recommendations:**

(U) Kearney recommends that the NRO continue to make the CAPCO process fully operational, to include ongoing training efforts to help CAPCOs distinguish between capital expenditures and expense costs. Management should monitor corrective action initiatives based on the results of testwork completed through the annual Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, assessment process. The CAPCO submission and quality metrics should continue to be part of the monthly Senior Assessment Team meetings to keep cost accumulation compliance on the forefront of all of the Program Offices' control environments.

(U) Kearney recommends the following additional corrective actions to improve the overall control environment for cost classification:

1. (U) As the NRO continues its refinement of the ACL ET/GLAC assessment documentation, a sustained focus should be placed on the level of detail included in the ACL to allow external parties to readily determine the basis on which assessments were made. The CAPCO validation forms will be helpful in this regard; however, if the CAPCO forms lack sufficient detail, the ACL should serve as the document of record and be capable of justifying the ET/GLAC assessment conclusions without additional support.
2. (U) The NRO should work to improve (U) communication between BPO/FIN and Program Offices to promote additional transparency of program operations potentially affecting the accuracy of the NRO's financial reporting. BPO/FIN and Program Offices should be more proactive in discussing current program operations and future changes that may require a reassessment of any currently reviewed work activities by the responsible CAPCO and BPO/FIN staff.
3. (U) BPO/FIN and Program Offices should discuss whether the Contract Data Requirements List (CDRL) pertaining to the submission of detailed cost data from acquisition contractors is appropriately aligned with the timing for the NRO's financial reporting requirements. For example, detailed cost data, which may be formally required from contractors in November, does not give the NRO the ability to make detailed assessments of costs, should the need arise through the compilation process to prepare the financial statements as of September 30.
4. (U) The NRO should enforce the execution of established internal controls over the [redacted] files as currently designed. The [redacted] file preparers should be more diligent in preparing the documentation, as well as tracing and agreeing the satellite acquisition costs to the general ledger accounts. Additionally, the [redacted] file reviewer should be more thorough in assessing each [redacted] file prior to signing off on the review. Variances noted in the preparation of the [redacted] files should be researched and resolved prior to the finalization of the files each quarter.

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II. (U) Significant Deficiency #2 – Deficiencies in System Access and Monitoring Controls (Repeat Condition)

~~(U//FOUO)~~ The purpose of access control is to limit access to computer resources (e.g., data, equipment, and facilities) and restrict unauthorized individuals from access to information systems and supporting hardware to prevent intentional and unintentional loss of resources. For access controls to be effective, they should be properly implemented and maintained. Inadequate access controls diminish the reliability of data and increase the risk of destruction or inappropriate disclosure of data.

~~(U//FOUO)~~ Access controls can consist of many areas, such as authorization of access and physical security. Authorization of access is used to allow or prevent actions by a specific individual based on predefined rules. [redacted]

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[redacted]

[redacted] The NRO has a standard process for the approval, tracking, and monitoring for all privileged user access. Ds and Os may have additional procedures for access to their specific systems and applications.

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[redacted]

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[redacted]

~~(U//FOUO)~~ Physical security controls restrict physical access to sensitive financial system resources and protect them from intentional or unintentional loss or impairment. Access to financial systems should be limited to personnel having a legitimate need for access to perform their duties and should be regularly monitored by management. [redacted]

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[redacted]

Security personnel require access to the data center for security and life safety concerns (e.g., fire, medical, security equipment malfunction/failure, water damage, electrical hazard, network analysis, etc.).

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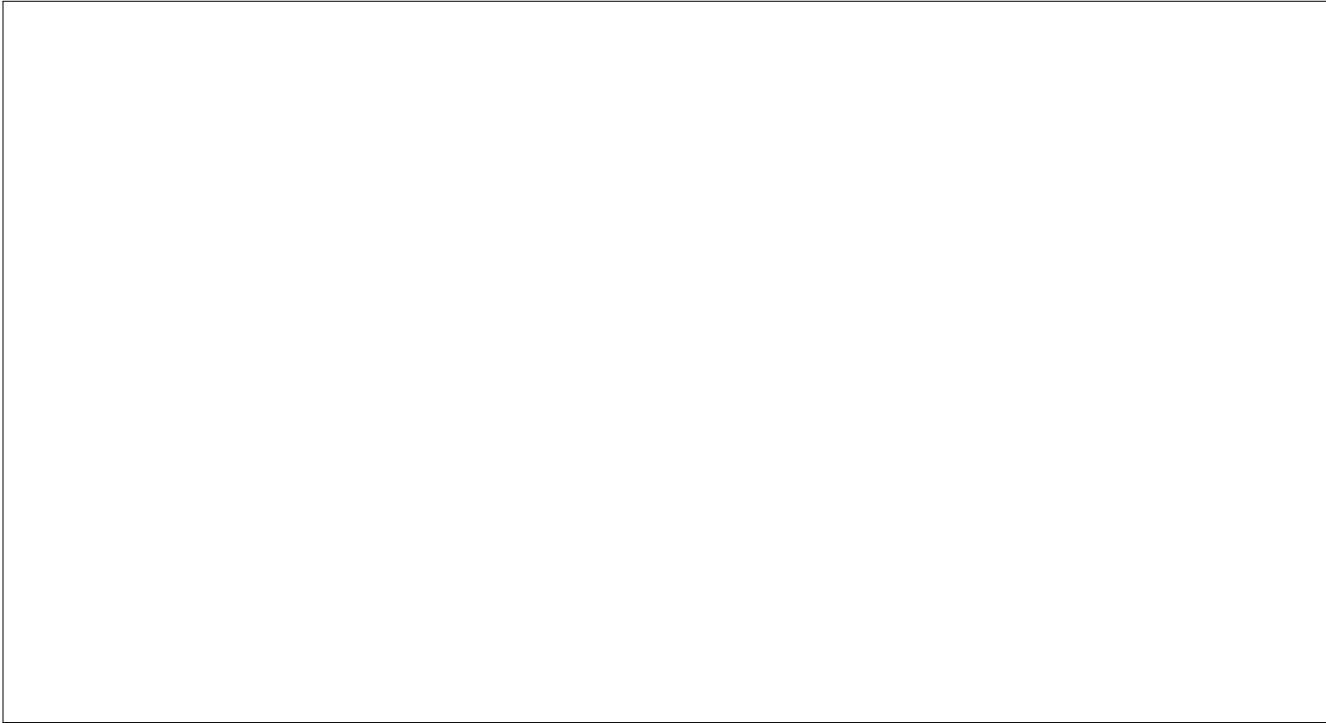
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(U) Recommendations:

(U) Kearney recommends that COMM [redacted] personnel should:

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- 1. (~~U//FOUO~~) Evaluate, strengthen, and enforce [redacted]

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- 2. (~~U//FOUO~~) Evaluate, strengthen, and enforce [redacted]

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- 3. (~~U//FOUO~~) Continue to coordinate with [redacted]

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- 4. (~~U//FOUO~~) Continue to evaluate [redacted]

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(~~U//FOUO~~) Additionally, COMM [redacted] and COMM personnel managing [redacted] should evaluate, strengthen, and enforce [redacted] in accordance with NRO policies

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(~~U//FOUO~~) COMM Security and COMM ISSOs should [redacted]

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[redacted] include documentation of reviews performed.

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(U//~~FOUO~~) MS&O/ [redacted] Security personnel should work with COMM [redacted] Administrators to [redacted]

[redacted] COMM [redacted]
[redacted]

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(U//~~FOUO~~) [redacted] Administrators should deploy a mechanism by which [redacted]
[redacted]

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III. (U) Significant Deficiency #3 – Deficiencies in the Establishment of Separation of Duties (Repeat Condition)

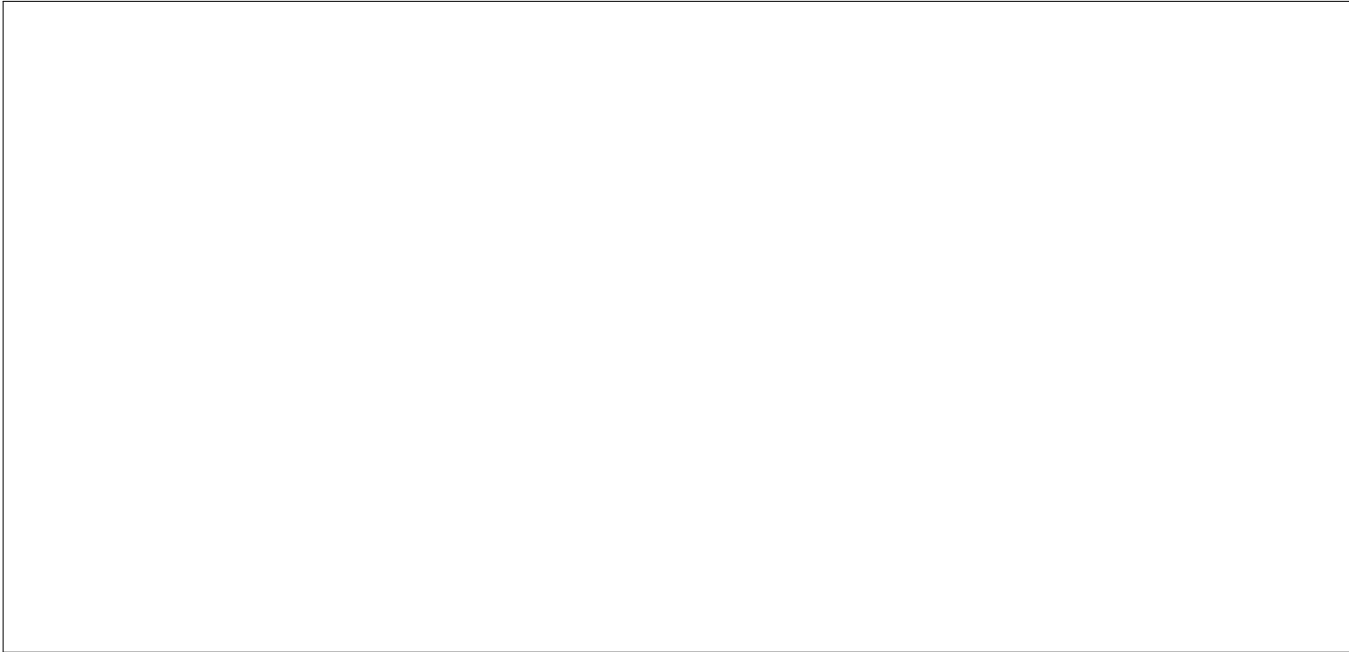
(U) A fundamental element of internal control is the segregation of certain key duties. The basic principle underlying segregation of duties is that no one individual should control all key aspects of a transaction or event. Inadequate segregation of duties contributes to an overall weakening of the internal control environment and increases the risk that errors and irregularities can occur and remain undetected. When separation of duties cannot be achieved due to organizational constraints (e.g., inadequate number of staff), compensating controls, such as logging and monitoring, should be implemented to detect any potential malicious activity within the system.

(U//~~FOUO~~) We identified deficiencies in

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(U) Recommendations:

(U) Kearney recommends that COMM [redacted] should:

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- 1. (U//~~FOUO~~) Formally document [redacted]
- 2. (U//~~FOUO~~) Periodically review [redacted]
- 3. (U//~~FOUO~~) For instances where valid business needs [redacted]

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(U) Additionally, COMM personnel managing [redacted] should:

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- 1. (U//~~FOUO~~) Formally document [redacted]
- 2. (U//~~FOUO~~) Periodically review [redacted]
- 3. (U//~~FOUO~~) For instances where valid business needs [redacted]

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