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OFFICE OF THE
INSPECTOR GENERAL

March 28, 2007

Mr. Daniel L. Shaw
Inspector General
National Endowment for the Arts
1100 Pennsylvania Avenue NW, Room 601
Washington, D.C. 20506

Dear Mr. Shaw:

We have reviewed the system of quality control for the audit function of the National Endowment for the Arts' Office of Inspector General (NEA/OIG) in effect for fiscal year 2006. A system of quality control encompasses NEA/OIG's organizational structure and the policies adopted and procedures established to provide the office reasonable assurance of conforming with generally accepted government auditing standards (GAGAS). The elements of quality control are described in GAGAS, promulgated by the Comptroller General of the United States. The design of the system, and compliance with it in all material respects, are the responsibility of NEA/OIG. Our objective was to determine whether the internal quality control system was adequate as designed and complied with to provide reasonable assurance that applicable auditing standards, policies, and procedures were met. Our responsibility is to express an opinion on the design of the system and NEA/OIG's compliance with the system based on our review.

Our review was conducted in accordance with the guidelines established by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. In performing our review, we obtained an understanding of the system of quality control for NEA/OIG. In addition, we tested compliance with the OIG's quality control policies and procedures to the extent we considered appropriate. These tests included the application of the OIG's policies and procedures on selected audits. Because our review was based on selective tests, it would not necessarily disclose all weaknesses in the system of quality control or all instances of lack of compliance with it. Nevertheless, we believe that the procedures we performed provide a reasonable basis for our opinion. Our scope and methodology are specified in Enclosure A.

Because there are inherent limitations in the effectiveness of any system of quality control, departures from the system may occur and may not be detected. Also, projection of any evaluation of a system of quality control to future periods is subject to the risk that

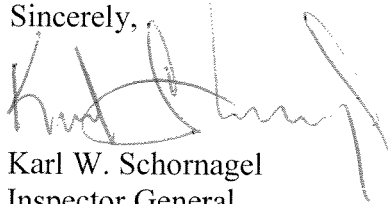
the system of quality control may become inadequate because of changes in conditions, or because the degree of compliance with the policies or procedures may deteriorate.

In our opinion, NEA/OIG's system of quality control in effect for FY 2006 was designed to meet the requirements of GAGAS. In addition, our selective tests of the system led us to conclude that the office's audit work conformed to its quality control system that year. Therefore, we believe there is reasonable assurance that NEA/OIG's audit work that year conformed to applicable auditing standards, policies, and procedures.

We are providing, in Enclosure B, some specific comments and recommendations to further enhance your quality control system. Your verbal response during the exit conference to these comments and recommendations are summarized after the recommendations. These issues do not affect our overall opinion of the NEA/OIG quality control system.

We appreciate the cooperation extended by you and your staff during this review.

Sincerely,

A handwritten signature in black ink, appearing to read 'Karl W. Schornagel', written over a faint, dotted grid background.

Karl W. Schornagel
Inspector General

Enclosures

Peer Review Scope and Methodology**Scope and Methodology**

We tested compliance with the NEA/OIG's system of quality control to the extent we considered appropriate. These tests included a review of one of the three limited scope audits listed in the semiannual reports issued for fiscal year (FY) 2006. In addition, we reviewed NEA/OIG's monitoring of the Independent Public Accountant's (Leon Sned & Company, P.C.) audit of NEA's FY 2006 financial statements.

Audit Reports Reviewed

<u>Report Number</u>	<u>Report Date</u>	<u>Report Title</u>
LS-06-02	2/15/2006	Northeast Document Conservation Center, Inc.
	11/02/2006	National Endowment for the Arts Audit of Financial Statements as of and for the Years Ended September 30, 2006 and 2005

Comments on NEA/OIG's Quality Control System

Comment 1. Quality Control and Assurance

GAGAS 3.50 indicates that an audit organization's system of quality control should provide the organization reasonable assurance that it is complying with GAGAS. The standard also indicates that an organization's internal quality control system should include procedures for monitoring, on an ongoing basis, whether the organization's policy and procedures related to GAGAS are suitably designed and are being effectively applied.

Section 404 of NEA/OIG's Audit Policy and Procedures Manual provides an effective means to implement GAGAS 3.50. That section indicates that the office addresses the GAGAS requirement through documented audit operating policies and procedures, supervision of audit staff, report referencing, and external peer reviews. In addition, Section 804 of the manual provides procedures for referencing the office's audit reports and establishes the policy that all NEA/OIG draft audit reports will be subjected to the section's referencing procedures.

Notwithstanding the office's stated quality control and assurance policy and procedures, NEA/OIG does not conform to its report referencing policy and does not subject its audit reports to its referencing procedures. The policy and procedures are not applied because the IG believes that there is no effective way to implement them due to the size of the office staff, which includes three members counting the IG, and the staff's close and virtually continuous interaction on OIG activities.

Recommendation - The NEA Inspector General should establish and implement an alternative quality control procedure(s) that, when applied in combination with the other elements of NEA/OIG's quality control and assurance program, provides ongoing assurance that the office is complying with GAGAS. Among such alternatives, the NEA IG should give strong consideration to acquiring the services of a qualified auditor, either on contract or on detail from another federal agency, to provide independent referencing of NEA/OIG's draft audit reports.

Views of Responsible Official - The NEA Inspector General generally concurred with the recommendation.

**Comment 2. Monitoring the Independent Public Accountant's
Audit of the NEA's FY 2006 Financial Statements**

Chapter 800 of NEA/OIG's Audit Policy and Procedures Manual documents the office's policies and procedures for monitoring an Independent Public Accountant's (IPA's) work related to audits of NEA's annual financial statements. Nevertheless, the audit manual could be enhanced by including language that requires the audit staff to comply with Sections 650.09b, 650.10, 650.36, 650.51, 650.57, 650A, and 1003 (Financial

Statement Audit Completion Checklist) of the GAO/PCIE Financial Audit Manual (FAM).

In addition, the peer review team’s evaluation of NEA/OIG’s monitoring of the IPA audit of NEA’s FY 2006 financial statements disclosed that NEA/OIG did not conform to:

- FAM Sections 650.09b and 650.10 which indicate that a letter expressing no assurance should be used to transmit the IPA’s audit report to the agency (ref. FAM Section 650C- *Example Reports When Using the Work of Others*).
- FAM Section 650.36 which requires a written plan for reviewing the IPA’s work. The plan should specify the level of review that will be employed (NEA/OIG employed a low level review in this case).
- FAM Section 650.51 which recommends a determination as to whether the IPA’s work is sufficient and acceptable and the preparation of a summary memorandum to document the OIG’s evaluation.
- FAM Sections 650.57, 650A, and 1003 which prescribe the documentation required for each level of IPA monitoring. Specifically, NEA/OIG did not retain copies of the IPA’s audit programs, summary memos, or the audit completion checklist.

Recommendation - The NEA Inspector General should enhance the Audit Policy and Procedures Manual for monitoring the IPA’s financial statement audit by including language that requires the audit staff to comply with Sections 650.09b, 650.10, 650.36, 650.51, 650.57, 650A, and 1003 (Financial Statement Audit Completion Checklist) of the FAM.

Views of Responsible Official - The NEA Inspector General generally concurred with the recommendation.

Comment 3. Proposed Enhancements for the Audit Manual

Overall, NEA/OIG’s Audit Policy and Procedures Manual provides effective means to implement GAGAS requirements. Nevertheless, the manual could be enhanced by including language that specifically establishes or identifies the office’s procedures for addressing various subjects. Portions of the manual that could be enhanced, related GAGAS requirements, and proposed enhancements to the manual are as follows.

<u>NEA/OIG Manual</u>	<u>GAGAS Requirement</u>	<u>Proposed Enhancement</u>
Section 401	GAGAS 3.40	Identify procedures for hiring competent staff and evaluating staff performance.

<u>NEA/OIG Manual</u>	<u>GAGAS Requirement</u>	<u>Proposed Enhancement</u>
Section 402	GAGAS 3.10-3.18	Reflect consideration of nonaudit services. Identify procedures to ensure such services do not impair NEA/OIG's independence.
Chapter 600	GAGAS 7.69	Establish policies and procedures for the safe custody and retention of audit documentation after completing consultation with the National Archives and Records Administration.
Chapter 700	GAGAS 6.03	Establish policy that permits an attestation engagement only if there is reason to believe the subject matter is capable of evaluation against suitable criteria.
Chapter 700	GAGAS 6.15 - 6.20	Identify procedures related to the detection of fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse during attestation engagements.
Chapter 800	GAGAS 5.14	Establish procedures (for financial audits) to identify reportable conditions considered to be material weaknesses when reporting deficiencies in internal control.
Omission	GAGAS 4.09, 6.09, 7.40	Identify policy and procedures for documenting audits and attestation engagements that are terminated prior to completion and for communicating the termination to appropriate parties.

Recommendation - The NEA Inspector General should incorporate the proposed enhancements into the Audit Policy and Procedures Manual.

Views of Responsible Official - The NEA Inspector General generally concurred with the recommendation.

The Manual has been revised to include the GAS requirements and proposed enhancements.