



Independent Auditor's Report

Inspector General, National Endowment for the Arts
Chairman, National Endowment for the Arts

Report on the Financial Statements

We have audited the accompanying Balance Sheet of the National Endowment for the Arts (NEA) as of September 30, 2016, and the related Statements of Net Cost, Changes in Net Position, and Budgetary Resources for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

NEA management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial statement audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 15-02 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered internal control relevant to the NEA's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the NEA's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness

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of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the National Endowment for the Arts as of September 30, 2016, and its net cost, changes in net position, and budgetary resources for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matters

The financial statements of NEA as of September 30, 2015 were audited by other auditors who issued an unmodified opinion dated November 23, 2015.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB) who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

Other Accompanying Information

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The performance measures, Summary of Management Challenges, Summary of Financial Statement Audit and Management Assurances, and reporting details related to the Improper Payments Improvement Act, as amended by the Improper Payments Elimination and Recovery Act, are presented for the purposes of additional analysis and are not required parts of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our reports dated October 31, 2016, on our consideration of the NEA's internal control over financial reporting and 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 control 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* in considering the NEA's internal control over financial reporting and compliance.

Report on Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the NEA'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 NEA's internal control. Accordingly, we do not express an opinion on the effectiveness of the NEA's internal control. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

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 a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the NEA's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a 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.

In our fiscal year 2016 audit, we noted two matters that we considered to be significant deficiencies (16-01 and 16-02) as described in Exhibit 1.

In addition, although not considered to be material weaknesses or significant deficiencies, we noted certain other matters that were communicated to management in a separate letter.

NEA's management's response to the significant deficiencies have not been subject to the auditing procedures applied in the audit of the financial data and other information and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the response or the effectiveness of any corrective actions described therein.

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 NEA's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the NEA's internal control. Accordingly, this communication is not suitable for any other purpose.

Report on Compliance and Other Matters

As part of obtaining reasonable assurance about whether NEA's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain provisions of other laws and regulations specified in OMB Bulletin No. 15-02. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 15-02.

We also performed tests of its compliance with certain provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of FFMIA disclosed no instances in which the NEA's financial management systems did not substantially comply with the (1) federal financial management system requirements, (2) applicable federal accounting standards, and (3) application of the United States Government Standard General Ledger at the transaction level.

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on the NEA's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the NEA's compliance. Accordingly, this communication is not suitable for any other purpose.

Williams, Adley & Company - DC, LLP
Washington, District of Columbia
October 31, 2016

16-01: NEA should improve its process for reviewing open obligations and updating Delphi in a timely manner to reflect GMS grant information

NEA should improve its processes related to obligations to include a review of all open obligations, a timely update of Delphi, and the deobligation of inactive grant obligations.

Review of Open Obligations

We requested NEA provide support to determine if they are actively reviewing open obligations. NEA was able to provide support for their review of open grants, but not for open contracts. Based on this, we believe NEA does not have an effective process for reviewing *all* open obligations on a regular basis.

Update of Delphi (General Ledger)

In addition, we noted that period of performance data in Delphi did not always agree with information in the Grant Management System (GMS). During our review of the grants that have been open for more than 18 months as of June 30, 2016, we found that 80 out of 167 grants had their period of performance extended in the Grant Management System (GMS), however, the Finance Office had not updated the period of performance in Delphi. The period of performance time difference between Delphi and GMS was between five (5) months to three (3) years.

Deobligation

Similarly, funds for 26 out of 167 grants were deobligated in GMS but were not deobligated in Delphi. The total dollar value that should have been deobligated in Delphi for these 26 grants is \$187,996, which means that the grant obligations in GL account 4801-*Undelivered Orders-Obligations, Unpaid* were overstated by \$187,996 at June 30, 2016. Also, we noted that the grants liability amount in General Ledger (GL) account 2190- *Other Liabilities with Related Budgetary Obligations* was overstated by the same amount.

The population of open obligations at September 14, 2016 was \$122,256,464. Per our analysis, dates of last activity in Delphi for \$115,764,046 (grants and contracts amounts) ranged from 1 month to 8 years. This shows that some amounts have been open for a long period of time without any activity.

Also, we requested NEA provide a list of open obligations that tied to the balance of GL account 4801- *Undelivered Orders- Obligations, Unpaid* as of September 14, 2016. NEA was not able to produce a report that tied to the trial balance. The difference between the adjusted balance of account 4801 and the UDO report provided was \$148,082.

NEA Directive 1650- Administrative Control of Funds states that the Finance Officer reports to the Deputy Chairman for Management and Budget and serves as the Agency's Chief Financial Officer. The Finance Officer, as Director of the Finance Office, is responsible for the Arts Endowment's financial systems and for the establishment and maintenance of financial records and reports.

Exhibit 1
Significant Deficiencies

Specifically, the Finance Officer should ensure that unpaid balances of obligations are valid and that invalid or excess balances are promptly deobligated.

Additionally, the GAO *Standards for Internal Controls in the Federal Government* (the “Green Book”) states the following in sections 12.02, 12.03, and 12.04.

Section 12.02- Management documents in policies the internal control responsibilities of the organization.

Section 12.03- Management documents in policies for each unit its responsibility for an operational process’s objectives and related risks, and control activity design, implementation, and operating effectiveness.

Section 12.04- Those in key roles for the unit may further define policies through day-to-day procedures, depending on the rate of change in the operating environment and complexity of the operational process. Procedures may include the timing of when a control activity occurs and any follow-up corrective actions to be performed by competent personnel if deficiencies are identified. Each unit, with guidance from management, determines the policies necessary to operate the process based on the objectives and related risks for the operational process. Each unit also documents policies in the appropriate level of detail to allow management to effectively monitor the control activity. Management communicates to personnel the policies and procedures so that personnel can implement the control activities for their assigned responsibilities.

NEA does not have a documented process (SOPs) for periodically reviewing open obligations to identify any issues that need to be corrected or followed up on. Also, existing SOPs do not document the process to ensure that grant information (e.g.; period of performance, deobligations) in GMS matches Delphi.

In addition, per NEA, they have experienced a significant staff turnover during calendar year 2015. Three of the seven Finance staff members (including the Director of Finance) were on-boarded in the last seven months. As a result, there were some processes that were not completed (e.g. timely update of period of performance and deobligations).

NEA stated that they are in the process of updating their policies and procedure to document the open obligation review process, but those documents have not been completed as of the report date.

If NEA does not perform a regular review of all open obligations, they may have un-used funds that could be better used to further NEA’s program operations and obligations that may no longer be valid.

Also, not updating Delphi in a timely manner results in NEA not having up-to-date information about available funds for decision making purposes. For example, NEA may have funds that could

be deobligated and used for other purposes, but this becomes difficult to determine if Delphi is not up-to-date to reflect GMS information. Specifically, we noted that the grants obligation amount was overstated in Delphi by \$187,996 as of June 30, 2016, because it did not reflect the deobligations performed in GMS.

Not having a documented process for the grant open obligation review could lead to NEA not following a uniform process if additional staff turnover were to occur.

We recommend that NEA management:

1. Develop and implement policies and procedures for performing a review of all open obligations. This process should include at a minimum:
 - The frequency of the review.
 - Who will perform and who will review/approve the open obligation review.
 - The criteria that will be used to determine if an amount should be deobligated.
 - Who will be responsible for authorizing a deobligation.
 - The person responsible for deobligating the amounts and the review and approval of this action.
2. Develop policies and SOPs that provide procedures, timelines, and responsibilities for updating Delphi in a timely manner to reflect GMS grant information.
3. Immediately update the period of performance and perform the necessary deobligations in Delphi to reflect the current information in GMS.
4. Periodically review obligations showing as expired in Delphi to determine whether the period of performance has been extended or if funds can be deobligated.
5. Perform an adjusting entry to correct the overstatement in GL account 2190- *Other Liabilities with Related Budgetary Obligations* and GL account 4801-*Undelivered Orders-Obligations, Unpaid*.

Management Response

NEA's management concurs with recommendations 1, 2, 3, and 4. We will ensure that there are written procedures, policies and SOPs as needed, and that periodic reviews are done and documented. We do not concur with recommendation 5 that recommended performing an adjusting entry to GL account 2190. Grant accrual is an estimate and the estimate is based on the payments status of each grant. In addition, since all 26 records have been properly deobligated and/or adjusted for the September 30 trial balance, there is no need to perform a journal entry.

See NEA's complete response in Exhibit 2.

Auditor Analysis:

We reviewed the grant accrual report as of October 3, 2016 and other supporting documentation provided and determined that NEA adjusted and/or deobligated these 26 grants in Delphi. Recommendation 5 is closed. In addition, we believe that the proposed actions are sufficient to close the remaining recommendations if properly implemented during FY2017.

16-02: Improvements Needed in NEA’s Internal Control Assessment Process

NEA’s internal controls assessment process, as required by Office of Management and Budget (OMB) Circular A-123, Appendix A, Internal Control Over Financial Reporting (herein referred to as “Appendix A”) should be enhanced to better address the intent of the OMB requirement and support management assertions. NEA’s current Appendix A process is unstructured, undocumented, and does not provide enough information or show adequate analysis to support NEA’s management assertions.

The current process relies on each director preparing a memo to the Special Assistant to the Deputy Chairman of Management & Budget that includes an overview of any known issues and any improvements they are making to internal controls within their unit. However, there is no consistent, agency-wide procedure or guidance on how the adequacy of internal controls should be determined or what criteria should be used. During discussions with several directors, we noted that each chief used a different methodology for evaluating the adequacy of internal control within their unit and none of these processes were structured, documented, or were based on an agency-wide assessment plan or methodology.

Specifically, NEA’s current process does not include:

- A formal identification of the Senior Assessment Team. This team is responsible for the overall objectives, communication, design, staffing, and scope of the assessment.
- An evaluation of internal controls at the entity level, including an evaluation of each of the five elements of internal control (control environment, risk assessment, control activities, information and communication, and monitoring).
- An evaluation of internal control at the process, transaction, or application level. For internal controls determined to be effective or moderately effective, some level of testing should be conducted to determine the extent to which the controls were applied, the consistency of their application, and who applied them. If testing indicates that a significant control is not operating as designed, it should be reported as a deficiency.

Furthermore, NEA has not documented many of its internal control processes, as required by Appendix A (section IV.A). Since joining NEA in April 2016, the Finance Director has attempted to formally document some of the key internal control processes that pertain to financial reporting and other key functions in the form of Standard Operating Procedures (SOPs), however as of the conclusion of our testwork, there were still many key areas that remained undocumented.

OMB Circular A-123, Appendix A, Internal Control Over Financial Reporting, provides specific, detailed elements for an agency's internal control assessment process and documentation that is required related to that process.

Specifically, Appendix A requires agencies to:

- A. Establish a Senior Assessment Team (Section III.A). Appendix A, Section III.A provides details of the duties and responsibilities of the team.
- B. Evaluate Internal Control at the Entity Level (Section III.B). This includes an evaluation of each of the five elements of internal control (control environment, risk assessment, control activities, information and communication, and monitoring).
- C. Evaluate Internal Control at the Process, Transaction, or Application Level (Section III.C). This includes:
 1. Determine Significant Accounts or Groups of Accounts
 2. Identify and Evaluate the Major Classes of Transactions
 3. Understand the Financial Reporting Process
 4. Gain an Understanding of Control Design to Achieve Management's Assertions
 5. Controls Not Adequately Designed
 6. Test Controls and Assess Compliance to Support Management's Assertions.

In addition, Appendix A, Section IV, provides documentation requirements for agencies to:

- A. Documenting Internal Control over Financial Reporting
- B. Documenting the Assessment of Effectiveness

The documentation may be electronic, hard copy format, or both, and should be available for review. Documentation should also include appropriate representations from officials and personnel responsible for monitoring, improving and assessing internal controls.

Due to a lack of understanding of how to apply Appendix A requirements to a small agency environment, NEA has not developed a policy or SOP related to its Appendix A assessment process, resulting in the current process being unstructured and varying significantly between units.

Without a structured, comprehensive, and documented Appendix A process, management cannot be sure that its assurance statement is accurate. Without documentation and understanding of key internal control processes, improvements cannot be made where needed. In addition, during periods of high turnover, such as what NEA experienced in FY2015/2016, knowledge of many controls and processes can be lost or performed inconsistently.

We recommend that NEA management:

1. Formally establish a Senior Assessment Team to oversee the implementation of Appendix A within the agency. The establishment, authority, and members of the team should be

documented.

2. Establish an agency-wide process for evaluating internal controls, including:
 - a. an evaluation of internal controls at the entity level,
 - b. an evaluation of internal control at the process, transaction, or application level, and
 - c. an overall assessment of the design and operation of internal control.
3. Formally document NEA's policies and procedures for complying with Appendix A.
4. Communicate NEA's revised Appendix A process with personnel who are participating in the evaluation.
5. Identify all key processes related to financial reporting and other key financial objectives. Determine whether adequate documentation of these processes exists. Where adequate documentation does not exist, policies, procedures, and/or SOPs should be developed and approved by management.
6. Review policies, procedures, and SOP documentation annually and update as necessary.

Management Response

NEA's management concurs with recommendations 1 through 6. We are revising our internal control assessment and reporting process to define new standards, and will create documentation to conform with the July 2016 revisions to Circular A-123. We previously informed the Auditors that we were developing a new framework and implementing an Enterprise Risk Management process during FY2017. We will ensure that the Enterprise Risk Management Process and the new Internal Control Assessment Process meet the requirement outlined in Circular A-123.

See NEA's complete response in Exhibit 2.

Auditor Analysis:

We believe that the proposed actions are sufficient to close the recommendation if properly implemented during FY2017.



November 8, 2016

Mr. Kola Isiaq, Partner
Williams, Adley, and Company, LLP-DC
1030 15th Street NW Suite 350 West
Washington, DC 20005

Mr. Isiaq,

This is the National Endowment for the Arts (NEA) Management response to the Independent Auditor's Report on Internal Control over Financial Reporting.

16-01: NEA should improve its process for reviewing open obligations and updating Delphi in a timely manner to reflect GMS grant information

NEA's Management Response to 16-01:

Review of Open Obligations

The NEA does conduct reviews of open obligations on both grants and contracts on a monthly basis. The NEA Grants Office provides information directly to the Budget and Finance Offices regarding grants that are deobligated. These actions occur on a weekly and monthly basis. In addition, as part of the grant accrual process, the Finance Office monitors undelivered orders data on a quarterly basis. This process is outlined in the Grant Accrual Standard Operating Procedures (document attached).

The NEA Finance Office tracks open obligations on a tracking sheet for contracts every month. The obligations are reviewed each month as payments are made. The process is outlined in the Finance Payment Process, Standard Operating Procedures (document attached).

Update of Delphi (General Ledger)

The NEA has updated the process for General Ledger entry. In the 4th quarter of 2016, a process and procedure was set up between the Finance Office and Grants Office. A senior Finance accountant coordinates with the Grants Office and generates reports from the GMS. The Grants Office reviews and confirms the accuracy of the performance end date and the extension of performance end date in Delphi. Although this is the practice in NEA, the practice was not previously documented in an SOP.

Deobligation

As a result of our research on the 26 grants that made up the adjusting journal entry, we have confirmed that all 26 grants have been deobligated or adjusted properly in our September 30 journal entry. Therefore, our trial balance was accurate at year end and there is no need to do an adjustment. In addition, the underlying June journal entry which forms the basis of the proposed adjustment was promptly reversed in July. The detailed support is provided with the Management Representation letter.

NEA has compensating controls from the Budget and Grants Office as it relates to deobligations for grants. The Grants Office sends deobligation requests to the Budget and Finance Offices. The Budget Director keeps a tracking list of program deobligations in Delphi and works with Finance, on a monthly, sometimes weekly, basis, to ensure deobligations are done timely.

We concur with Recommendations 1, 2, 3, and 4; we will ensure that there are written procedures, policies and SOPs as needed; and that periodic reviews are done and documented.

We do not concur with Recommendation 5 that recommended performing an adjusting entry to GL account 2190. As described earlier, grant accrual is an estimate and the estimate is based on the payment status of each grant. In addition, since all 26 records have been properly deobligated and/or adjusted for the September 30 trial balance, there is no need to perform a journal entry.

16-02: Improvements Needed in NEA's Internal Control Assessment Process

NEA's Management Response to 16-02:

The NEA does have an internal control assessment process that has been used for more than ten years that is known by the managers, structured, documented, and reliable. In 13 years of previous audits, the methodology NEA used for internal control assessment was considered acceptable under the requirements of OMB Circular A-123 and its Appendix A. We disagree with the characterization that "Due to a lack of understanding of how to apply Appendix A requirements to a small agency environment," etc. The NEA does not have a lack of understanding; the process used in the past for internal control assessment was appropriate for the NEA at that time. For an agency of our size and operating structure, we stand behind the years of Management Assurance statements as accurately representing the state of our internal control.

We are revising our internal control assessment and reporting process to define new standards, and will create documentation to conform with the July 2016 revisions to Circular A-123. We previously informed the Auditors that we were developing a new framework and implementing an Enterprise Risk Management process during FY 2017. We will ensure that the Enterprise Risk Management Process and the new Internal Control Assessment Process meet the requirements outlined in Circular A-123.

Regarding financial reporting specifically, we note that our Finance Office is very conscientious about internal control over financial reporting. In particular, the Finance Director conducted an overall review of the process for transactions in both sub ledger and general ledger.

This review included:

- Significant and key general accounts, Treasury Account Symbol (TAS), and NEA fund types, such as program funds vs. administrative funds.
- Key and major classes of transactions such as accounts receivable, accounts payable, asset purchases and capitalization, obligations, de-obligations, donations, interagency agreements, and reimbursable transactions.
- Understanding the impact of transactions on the financial reporting process.
- Understanding and implementing Treasury tie point, general ledger account abnormal analysis, and key account variance analysis to ensure the integrity of financial reporting and support management assertions.
- Designing and implementing account reconciliations to ensure accuracy of financial reporting.

The Finance Office has developed SOPs for nearly all major transaction functions and key reconciliation processes. In fiscal 2017, additional SOPs will be developed.

We concur with the recommendations 1 through 6.

Sincerely,



Winona H. Varnon
Deputy Chairman
Office of Management and Budget