WILLIAMS ADLEY

Independent Auditor's Report

Chairman
National Endowment for the Arts

Inspector General
National Endowment for the Arts

In our audits of the fiscal years 2018 and 2017 financial statements of the National Endowment for the Arts (NEA), we found:

- NEA's financial statements as of and for the fiscal years ended September 30, 2018, and 2017, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- no material weaknesses in internal control over financial reporting based on the limited procedures we performed; [1] and
- no reportable noncompliance for fiscal year 2018 with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements, which includes an emphasis of matter paragraph related to the new Statement of Budgetary Resources presentation, and required supplementary information (RSI)[2] and other information included with the financial statements; [3] (2) our report on internal control over financial reporting; (3) our report on compliance with laws, regulations, contracts, and grant agreements; and (4) agency comments with auditor evaluation.

Report on the Financial Statements

In accordance with the standards applicable to financial 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. 19-01, *Audit Requirements for Federal Financial Statements*, we have audited NEA's financial statements. NEA's financial statements comprise the balance sheets as of September 30, 2018, and 2017; the related statements of net cost, changes in net position, and budgetary resources for the fiscal years then ended; and the related notes to the financial statements.

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[1] A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, 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 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.

[2] The RSI consists of Management's Discussion and Analysis section which is included with the financial statements.

[3] Other information consists of Message from the Chief Financial Officer, and Other Information section and appendices.

WILLIAMS, ADLEY & COMPANY-DC, LLP
Certified Public Accountants / Management Consultants
1030 15th Street, NW, Suite 350 West • Washington, DC 20005 • (202) 371-1397 • Fax: (202) 371-9161
www.williamsadley.com

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

Management's Responsibility

NEA's management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and the RSI; and (4) maintaining effective internal control over financial reporting, including 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 audits. U.S. generally accepted government auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. We are also responsible for applying certain limited procedures to RSI and other information included with the financial statements.

An audit of financial statements 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 auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity'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 entity's internal control. Accordingly, we express no such opinion. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audits also included performing such other procedures as we considered necessary in the circumstances.

Opinion on Financial Statements

In our opinion, NEA's financial statements present fairly, in all material respects, NEA's financial position as of September 30, 2018, and 2017, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matter

As described in note 1B to the financial statements, OMB Circular A-136, *Financial Reporting Requirements*, required federal agencies in fiscal year 2018 to present their budgetary information in a format different than that used in fiscal year 2017. We draw attention to the newly presented information in NEA's fiscal years 2018 and 2017 Statement of Budgetary Resources and related note 14. Our opinion on NEA's financial statements is not modified with respect to this matter.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI is not a part of the financial statements, FASAB considers this information to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit, and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

NEA's other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on NEA's financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

Report on Internal Control over Financial Reporting

In connection with our audits of NEA's financial statements, we considered NEA's internal control over financial reporting, consistent with our auditor's responsibility discussed below. We performed our procedures related to NEA's internal control over financial reporting in accordance with U.S. generally accepted government auditing standards.

Management's Responsibility

NEA management is responsible for maintaining effective internal control over financial reporting, including 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

In planning and performing our audit of NEA's financial statements as of and for the year ended September 30, 2018, in accordance with U.S. generally accepted government auditing standards, we considered NEA's internal control over financial reporting as a basis for designing 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 NEA's internal control over financial reporting. Accordingly, we do not express an opinion on NEA's internal control over financial reporting. We are required to report all deficiencies that are considered to be significant deficiencies[4] or material weaknesses. We did not consider all internal controls relevant to operating objectives, such as those controls relevant to preparing performance information and ensuring efficient operations.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error.

Results of Our Consideration of Internal Control over Financial Reporting

Our consideration of internal control was for the limited purpose described above, and was not designed to identify all deficiencies in internal control that might be material weaknesses and significant deficiencies or to express an opinion on the effectiveness of NEA's internal control over financial reporting. Given these limitations, during our audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

As discussed in Appendix I in more detail, our 2018 audit identified a deficiency in NEA's controls relating to its grant accrual accounting estimation process that represents a significant deficiency in NEA's internal control over financial reporting. We considered this significant deficiency in determining the nature, timing, and extent of our audit procedures on NEA's fiscal year 2018 financial statements.

Although the significant deficiency in internal control did not affect our opinion on NEA's fiscal year 2018 financial statements, misstatements may occur in unaudited financial information reported internally and externally by NEA because of the significant deficiency.

In addition to the significant deficiency, we also identified other control deficiencies in NEA's internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant NEA management's attention and, accordingly, we have communicated these matters to NEA management in a separate letter.

Intended Purpose of Report on Internal Control over Financial Reporting

The purpose of this report is solely to describe the scope of our consideration of NEA's internal control over financial reporting and the results of our procedures, and not to provide an opinion on the effectiveness of NEA's internal control over financial reporting. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering internal control over financial reporting. Accordingly, this report on internal control over financial reporting is not suitable for any other purpose.

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[4]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

In connection with our audit of NEA's financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Management's Responsibility

NEA's management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to NEA.

Auditor's Responsibility

Our responsibility is to test compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements applicable to NEA that have a direct effect on the determination of material amounts and disclosures in NEA's financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to NEA.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for fiscal year 2018 that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to NEA. Accordingly, we do not express such an opinion.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments and Auditor Evaluation

In commenting on a draft of this report, NEA management provided a written response which is presented in Appendix II. We did not audit NEA's response and, accordingly, we express no opinion on the response.

Williams, Adley & Company-DC, LLP

Washington, D.C.
November 14, 2018

Appendix I
Significant Deficiency

2018-01 Grant Accrual Accounting Estimation Process

Background and Criteria:

Accounting principles generally accepted in the U.S. (GAAP) require entities to prepare financial statements on an accrual basis and such principles also require entities to validate assumptions made in the accrual accounting process.

NEA's grant and cooperative agreement cost (collectively referred to as grant expenditures) is comprised of two components: 1) actual grant expenses paid to the grantees pursuant to NEA's manually intensive expense reimbursement program, and 2) an estimate of expenditures incurred by the grantees, for which a reimbursement request had not yet been submitted to NEA (referred to as the "Incurred but Not Reported" (IBNR) grant accrued liability). The Federal Accounting Standards Advisory Board (FASAB) Technical Release (TR12) "*Accrual Estimates for Grant Programs*" specifically addresses the process for preparing accrual estimates for grant programs.

Prior to fiscal year 2018, reliable data of grantees' spending patterns was not available, and based on grantees' fluctuating spending patterns from year to year, NEA calculated the IBNR grant accrued liability using a "straight line" methodology. Such calculation was substantially based on the number of days remaining in the grant agreement term at the end of the year, less amounts paid to the grantee. Accordingly, at September 30, 2017, NEA estimated its IBNR grant accrued liability at $47.1 million. This methodology was considered appropriate prior to fiscal year 2018 because, pursuant to TR12, the grant accrued liability estimate was "based upon the best available data at the time the estimates were made." Historically, due to the limitations of NEA's grant accounting reporting system, grant accrual estimates were not validated in the subsequent year as required by TR12.

In October 2017, NEA implemented a new grantee cash request and expenditure reporting system, Electronic Grants Management System (eGMS). This system significantly changed, through automation, the manner in which grantees requested reimbursement for grant expenditures for their awards. With the implementation of eGMS, the period to which the grant expense reimbursement related was captured in eGMS, enabling additional analysis.

Condition:

In response to the concern we raised during the fiscal year 2018 audit regarding the reasonableness of NEA's methodology to estimate the IBNR grant accrued liability, NEA utilized data in eGMS to review payment history to assess the reasonableness of the IBNR estimate in order to fully comply with TR12 in calculating the IBNR at September 30, 2018.

Accordingly, in October 2018, using the newly available grantee pay request information in eGMS, NEA performed an analysis as required by TR12 "comparing the estimates with subsequent grantee reporting." Such analysis is often referred to as a "Look Back" validation of the prior year grant accrual estimate. As a result of this analysis, NEA determined that its straight-line based IBNR estimate at September 30, 2017 was understated. In applying the results of the fiscal year 2017 Look Back analysis to the grant accrual estimate at September 30, 2018, NEA determined that the initial grant accrued liability recorded in its accounting system at September 30, 2018 was understated by approximately 7% or $4 million. Accordingly, NEA increased its grant accrued liability at September 30, 2018 to approximately $60 million. Since historical spending pattern data was not readily available prior to the implementation of eGMS in fiscal year 2018, pursuant to GAAP the full amount of the expense accounting adjustment noted above is considered a change in estimate, and therefore reflected in the fiscal year 2018 financial statements.

Appendix I
Significant Deficiency

Recommendations - We recommend that NEA:

1. Incorporate the "Look Back" analysis into NEA's Standard Operating Procedures. The annual "Look Back" analysis should evaluate the impact that the variability of grantee spending habits has on the grant accrual estimate from year to year and adjust the grant accrual estimate adjustment factor each year at June 30th and September 30th.
2. Analyze grantee spending pattern data available in eGMS and perform a Look Back analysis of the September 30, 2018 grant accrual estimate through June 30, 2019, and adjust the straight-line based grant accrual estimate in the NEA general ledger as of that date.
3. Update the fiscal year 2018 Look Back analysis through August 30, 2019 and consider the cumulative adjustment factor in recording the grant accrual estimate at September 30, 2019, as needed.
4. Assess the viability of the use of a statistically based Look Back analysis for the grant accrual estimate processes and implement if determined viable.

Appendix II
Management's Response to Independent Auditor's Report

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Date: November 13, 2018

To: Mr. Ronald Stith, Inspector General

From: Ann C. Eilers, Deputy Chairman for Management and Budget

Subject: Management's Response to Independent Auditors Report for Fiscal Year (FY) 2018 (Appendix II)

We reviewed the draft Independent Auditor's Report on the National Endowment for the Art's (NEA) FY 2018 financial statements. NEA received its 16th consecutive unmodified audit opinion on its financial statements and had no material weaknesses. I commend the NEA staff for their strong contributions and commitment to continuously improving operations and the internal controls of the Agency.

During FY2018 the NEA reached a major milestone in implementing the eGMS system, a system which through automation significantly improved the accuracy and efficiency of grant processing including analysis and reporting. The NEA is dedicated to further strengthening its controls over grant accruals and this system will be instrumental in addressing the four auditor recommendations:

1. To incorporate the "Look Back" analysis into NEA's Standard Operating Procedures to include practices where the "Look Back" analysis evaluates the impact that the variability of grantee spending habits has on the grant accrual estimate from year to year and adjustment of the grant accrual estimate accordingly.
2. To analyze grantee spending pattern data available in eGMS and perform a "Look Back" analysis of the grant accrual estimate and adjust the grant accrual estimate in the NEA general ledger.
3. To update the fiscal year 2018 "Look Back" analysis and consider the cumulative adjustment factor in recording the grant accrual estimate in future periods, as needed.
4. To assess the viability of the use of a statistically based "Look Back" analysis for the grant accrual estimate processes and implement if determined viable.

I would like to thank your staff and Williams Adley and Company, for their professionalism during the audit. We look forward to working cooperatively with you during the audit resolution process.