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September 16, 1999

TO: B/Chief Financial Officer

FROM: W/Assistant Inspector General for Auditing

SUBJECT: Final Report on the Audit of Selected Internal Controls Related to Financial  
Statement Audits  
Assignment Number A9904100  
Report Number IG-99-040

The subject final report is provided for your use and comment. Please refer to the Executive Summary for the overall audit results. Our evaluation of your response is incorporated into the body of the report. In response to management's comments, we revised recommendation 2. Please notify us when action has been completed on these recommendations, including the extent of testing performed to ensure corrective actions are effective. All recommendations remain open.

If you have questions concerning the report, please contact Mr. Chester A. Sipsock, Program Director, Environmental and Financial Management Audits, at (216) 433-8960, or Ms. Van Tran, Auditor-in-Charge, at (202) 358-0466. We appreciate the courtesies extended to the audit staff. See Appendix E for the report distribution.

**[original signed by]**  
Russell A. Rau

Enclosure

cc:

B/Comptroller

BF/Director, Financial Management Division

G/General Counsel

JM/Director, Management Assessment Division

bcc:  
B/L. Lauria  
AIGA, IG, Reading Chrons

**IG-99-040**

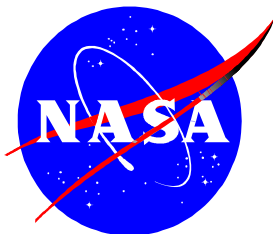
**AUDIT  
REPORT**

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**SELECTED INTERNAL CONTROLS  
RELATED TO FINANCIAL STATEMENT  
AUDITS**

**September 16, 1999**

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National Aeronautics and  
Space Administration

**OFFICE OF INSPECTOR GENERAL**

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## **Acronyms**

CATS	Corrective Action Tracking System
CFO	Chief Financial Officer
CPA	Certified Public Accountant
FY	Fiscal Year
OIG	Office of Inspector General
OMB	Office of Management and Budget
NPG	NASA Procedures and Guidelines

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# NASA Office of Inspector General

IG-99-040  
A9904100

September 16, 1999

## Selected Internal Controls Related to Financial Statement Audits

### Executive Summary

**Background.** The NASA Office of Inspector General (OIG) contracted with Arthur Andersen LLP, a certified public accounting (CPA) firm as the independent, external auditor, to audit the NASA fiscal year (FY) 1998 Financial Statements. To ensure the quality of the audit work performed, we completed a quality control review of Arthur Andersen's reports and related working papers.<sup>1</sup> The reports issued by Arthur Andersen principally provided (1) an opinion on the financial statements and (2) test results on internal controls and compliance with laws and regulations. These reports are required pursuant to provisions of the Office of Management Budget (OMB) Bulletin 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998.

As part of a financial statement audit, NASA management executes a management representation letter<sup>2</sup> that states, among other things, that the Agency has identified laws and regulations applicable to NASA. The audit should complement this representation by management by considering those laws and regulations determined to have a direct and material effect on the financial statements and related disclosures.

**Objectives.** Our overall objective was to evaluate selected internal controls related to financial statement audits. Specifically, we determined whether NASA identified significant provisions of laws and regulations for compliance purposes and established an effective follow-up system to address recommendations made by external auditors. Appendix A contains additional details on our objectives, scope, and methodology.

**Results of Audit.** Controls related to the Agency financial statements could be improved. NASA has identified certain laws and regulations that could have a direct and material effect on the financial statements. The Agency's list, however, was incomplete and did not agree with that of the external auditor (Finding A). As a result, the NASA management representation letter may not cover all significant laws and regulations, which would, in turn, be considered by the auditors in determining the scope of the audit. Further, NASA does not use its existing Agency-

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<sup>1</sup> The scope and results of our quality control review are summarized in Appendix B.

<sup>2</sup> The management representation letter serves to document representations explicitly or implicitly made by management in response to the auditors' specific inquiries and to reduce any misunderstandings that could arise relating to matters discussed in the representation letter. The letter must be signed, at a minimum, by the Agency Head and the Chief Financial Officer and must be submitted annually to the auditors.

wide Corrective Action Tracking System (CATS)<sup>3</sup> to track recommendations resulting from the financial statement audits (Finding B). Consequently, the Agency's reporting of the status of corrective actions on audit recommendations is not complete, and timely resolution and disposition in accordance with the established follow-up process may not occur.

**Recommendations.** We recommend that NASA:

- Require Agency financial management to annually coordinate with the external auditor in identifying the laws and regulations that have a direct and material effect on the financial statements and that are the basis for the management representation letter.
- Provide timely, semiannual status reports on the resolution and disposition of recommendations resulting from audits of financial statements.

**Management's Response.** Management concurred with the recommendations. The complete text of the response is in Appendix D. We consider management's comments responsive.

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<sup>3</sup> NASA has established procedures that include use of the CATS for following up, tracking, and reporting on the status of audit recommendations. The procedures are set forth in NASA Procedures and Guidelines 1200.1, "Management Accountability and Control, Audit Liaison, and Audit Followup," dated October 8, 1997.



## **Introduction**

The Chief Financial Officers Act of 1990 requires NASA to produce financial statements and the OIG to either audit or provide for an independent, external auditor to audit the statements. Starting with FY 1996, the OIG contracted with Arthur Andersen to audit the NASA financial statements. Our responsibilities for audits conducted under contract are identified in the Inspector General Act of 1978, as amended; the Chief Financial Officers Act of 1990, as amended; and OMB Bulletin 98-08, as amended. Generally, our responsibility is to ensure that the audit conforms to generally accepted government auditing standards and applicable statutory and regulatory requirements. Further, paragraph 10 of OMB Bulletin 98-08 requires the Inspector General to:

- ensure that audits are performed and audit reports are completed in a timely manner and in accordance with the Bulletin requirements;
- provide technical advice and a liaison to agency officials and independent, external auditors;
- perform quality control reviews and provide the results to interested organizations; and
- monitor and report on management's progress in resolving audit findings identified by independent, external auditors.

The NASA Office of the Chief Financial Officer (CFO) has overall responsibilities for producing the financial statements and for responding to the external auditor's findings and recommendations. In some instances, the recommendations involve other Headquarter Offices (such as the Offices of General Counsel, Policy and Plans, or Information Technology) and thus require the coordination of Agency officials.

The NASA Management Assessment Division, Office of Management Systems, has overall responsibility for tracking and reporting on the status of audit recommendations. As outlined in NASA Procedures and Guidelines (NPG) 1200.1, the responsibility encompasses managing CATS; drafting the required audit status reports to the Administrator and from the Administrator to Congress; and ensuring that NASA follow-up activities comply with OMB Circular A-50, "Audit Followup," and the Inspector General Act of 1978, as amended.

## **Findings and Recommendations**

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### **Finding A. Identifying Laws and Regulations**

NASA did not identify a complete list of laws and regulations that affect its financial statements and that are the basis for the management representation letter. The Agency considered it to be the auditor's responsibility to develop the list and to conduct associated compliance testing and thus did not make the listing available. A complete list, coordinated between NASA and the external auditor, would (1) ensure that all significant provisions of laws and regulations are tested for compliance and (2) provide the Agency assurance that it has adequately specified a minimum scope of compliance testing when re-competing future contracts for financial statement audits.

#### **Responsibilities for Identifying Significant Laws and Regulations**

NASA acknowledged its responsibility for the fair presentation of the financial statements by including certain written representations in its management representation letter, dated February 3, 1999, to Arthur Andersen. The NASA letter states:

- We are responsible for identification and compliance with laws and regulations applicable to NASA.
- We have identified and disclosed to you all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

Arthur Andersen is responsible for testing and reporting on NASA compliance. OMB Bulletin 98-08, section 6d, states, “. . . the auditor shall perform tests of compliance with laws and regulations that could have a direct and material effect on the [financial statements], and any other laws, regulations, and governmentwide policies identified by OMB in Appendix C of this Bulletin.” To aid in the identification process, auditors ordinarily review the lists of laws and regulations that the Agency and OMB have determined might be significant, in addition to those the auditors identified. Section 7c(3) then specifies the requirements for reporting on the Agency's compliance. In particular, auditors must state in the report whether tests disclosed reportable instances of noncompliance.

#### **Lists of Laws and Regulations**

While the Agency identified a list of applicable laws and regulations, the list was incomplete and did not agree with that of the external auditor. The CFO Office, for example, did not identify laws related to single audit or debt collection. Included on the CFO's list were the Government Performance and Results Act and Government Management Reform Act. Those acts were not on the auditor's list (see Appendix C). Arthur Andersen developed its list based on reviews of

OMB bulletins<sup>4</sup> and through discussions with NASA headquarters officials from the Offices of the General Counsel and Legislative Affairs. The lists differed primarily because the Agency did not coordinate its identification effort with that of Arthur Andersen. CFO officials stated that they did not provide the list to the external auditor for consideration because such action could potentially impair auditor independence. While we agree that the auditor must be able to independently set the scope of the audit, this does not preclude NASA management from identifying and communicating laws and regulations that affect its financial statements. It would be in the Agency's best interest to work with the external auditor in compiling one list and ensuring its completeness as there are other laws and regulations that could also materially affect NASA financial statements. Examples include certain provisions of the Federal Acquisition Regulation and the OMB bulletin<sup>5</sup> or circulars.<sup>6</sup> The management representation letter and the auditor report on NASA compliance should be consistent, specifically with regard to the laws and regulations tested.

Without better coordination, NASA has no assurance that all the significant laws and regulations that should be tested are tested for compliance. Moreover, the procurement process for the FY 2001 financial statement audit will soon begin. Adequately specifying contract requirements, such as the minimum scope of compliance testing to be performed, is essential to obtaining responsive offers for the contract.

## **Recommendation, Management's Response, and Evaluation of Response**

- 1. The Chief Financial Officer should annually coordinate with the external auditor in identifying the laws and regulations that NASA considers to have a direct and material effect on the financial statements and that are the basis for the management representation letter.**

**Management's Response.** Management concurred with the recommendation and will meet with the external auditors on September 20, 1999. The complete text of the comments is in Appendix D.

**Evaluation of Response.** The actions planned by management are responsive to the recommendation. The recommendation is resolved but will remain undispositioned and open until agreed-to corrective actions are completed.

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<sup>4</sup> OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, was amended by OMB Bulletin 98-08 on August 24, 1998. The bulletins identify the significant provisions of laws and regulations that are common to most Federal agencies. Noncompliance with those laws and regulations could have a direct and material effect on financial statements.

<sup>5</sup> OMB Bulletin 97-01, "Form and Content of Agency Financial Statements."

<sup>6</sup> OMB circulars related to Federal financial management include: A-50, "Audit Followup"; A-123, "Management Accountability and Control"; A-127, "Policies and Standards for Financial Management Systems"; A-133, "Audits of State, Local Governments, and Non-Profit Organizations"; and A-134, "Financial Accounting Principles and Standards."

## **Finding B. Tracking External Auditor Recommendations**

Although NASA has the CATS in place to track audit findings issued by Federal audit entities, NASA does not use the system to track findings or recommendations made by a non-Federal auditor, such as Arthur Andersen. Since the CPA firm is acting on behalf of the OIG in the performance of the audit, the same resolution and disposition procedures applicable to OIG reports should be used.<sup>7</sup> NPG 1200.1 currently does not address such requirements. As a result, recommendations resulting from the financial statement audits do not receive the same level of visibility as do those resulting from OIG audits.

### **Requirements Related to Audit Follow-up**

OMB Circular A-50, "Audit Followup," dated September 29, 1982, requires Federal agencies to establish follow-up systems to resolve audit findings issued by the Inspector General, other executive branch audit organizations, the General Accounting Office, and non-Federal auditors. A single tracking system, however, is not mandatory. For audits performed by non-Federal auditors, section 8(2) of the Circular requires prompt resolution (that is, within 6 months after receipt of the report by the agency) and completion of corrective actions on audit recommendations. The Circular also requires the preparation of semiannual reports to the agency head on the status of all unresolved audit reports more than 6 months old, the reasons for the delay, and a timetable for their resolution.

The semiannual reporting requirements are also in the Inspector General Act of 1978, as amended. Section 5(b) requires that the agency head submit a report to Congress detailing the status of various audit reports, including "a statement with respect to audit reports on which management decisions have been made but final action has not been taken. . . ." The semiannual report must also include an explanation as to why final action has not been taken on recommendations.

As set forth in NPG 1200.1, the NASA Management Assessment Division uses the Agency-wide CATS to track the status of audit activities (that is, audits in progress or corrective actions for each audit recommendation) of Federal audit organizations, such as the OIG, General Accounting Office, and Defense Contract Audit Agency. The tracking system allows for ad hoc query and reporting capabilities among the NASA Centers and Headquarters. The system also serves as the source for preparing the required follow-up status reports. NPG 1200.1 also provides detailed guidance on the resolution and disposition of audit recommendations issued by Federal audit organizations.

### **Current Tracking Process**

Although an Agency-wide follow-up system exists, NASA does not use it to track external auditor (that is, non-Federal auditor) recommendations. Instead, the Agency CFO office tracks

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<sup>7</sup>The OIG includes open and nondispositioned recommendations for corrective action in its semiannual report to the Congress.

the status of corrective actions internally. For recommendations pertaining solely to financial management, the CFO Office establishes action plans that address the findings and recommendations, distributes the action plans to the field Centers for implementation, and documents in its internal working papers the corrective actions taken. For recommendations involving other Headquarters offices, the CFO Office also coordinates the corrective action plans and tracks the implementation.

The above process could result in a lack of timely corrective actions on recommendations made by external auditors. In the FY 1997 Financial Statement Audit, for example, Arthur Andersen identified a reportable condition related to the need to improve information technology policies and procedures to prevent unauthorized access to NASA financial management systems. Because the CFO Office tracked the recommendation only internally, Agency officials may not have given it the needed emphasis to fully resolve the finding. When following up on this recommendation, Arthur Andersen found that corrective actions were not sufficient to correct the problem. Consequently, the external auditor reported the finding again in FY 1998.

### **Policy on the Use of the CATS**

The CFO Office does not use CATS to track recommendations made by the external auditor because existing policy does not require such use. The current NPG 1200.1 discusses requirements for the tracking, resolution, and disposition of recommendations issued by Federal audit entities only. Thus, recommendations made by Arthur Andersen, a non-Federal auditor, do not receive the same visibility, such as inclusion in the semiannual status reports to the NASA Administrator and Congress, as required by both OMB Circular A-50 and the Inspector General Act. The resolution and disposition status of the information technology finding, for example, was not discussed in the NASA Semiannual Management Report to Congress on the Status of Audit Followup, for the period ending September 30, 1998. This lack of visibility can and has resulted in repeat findings in the financial statement audits. By applying the same procedures to OIG and CPA firm audit reports, NASA can ensure effective follow-up or completion of agreed-to corrective actions.

### **Recommendation, Management's Response, and Evaluation of Response**

- 2. The NASA Chief Financial Officer should provide timely, semiannual status reports on the resolution and disposition of recommendations resulting from audits of financial statements.**

**Management's Response.** Management concurred with the recommendation and will provide status reports to the Inspector General and external auditors by September 30, 1999. The complete text of the comments is in Appendix D.

**Evaluation of Response.** The actions planned by management are responsive to the recommendation. The recommendation is resolved but will remain undispositioned and open until agreed-to corrective actions are completed.



## **Appendix A. Objectives, Scope, and Methodology**

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### **Objectives**

Our overall objective was to evaluate selected internal controls related to financial statement audits. Specifically, we determined whether NASA identified significant provisions of laws and regulations for compliance purposes and established an effective follow-up system to address recommendations made by external auditors.

### **Scope and Methodology**

We examined and tested applicable records and documentation (dated from October 1978 through May 1999) to identify applicable management controls and to verify that the controls were working as described. Specifically, we reviewed the NASA management representation letter, action plans, applicable NASA policy and procedures and guidelines, and applicable OMB circulars and bulletins. We also reviewed the external auditor's working papers supporting the FY 1998 financial statement audit.

### **Audit Field Work**

We conducted our audit from March through May 1999 at Headquarters in accordance with generally accepted government auditing standards.

## **Appendix B. Quality Control Review**

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NASA Inspector General report IG-99-018, “Quality Control Review of Arthur Andersen LLP Audit of the National Aeronautics and Space Administration Financial Statements for Fiscal Year Ended September 30, 1998,” March 31, 1999, states that Arthur Andersen conducted the audit in accordance with government auditing standards and provisions of OMB Bulletin 98-08. Specifically, Arthur Andersen planned, executed, and reported the results of its audit according to applicable standards and issued the reports in a timely manner. Report IG-99-018 also summarized results of Arthur Andersen’s audit and status of prior year audit recommendations.



## Appendix C. Lists of Laws and Regulations

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### Laws and Regulations Identified by the Office of Chief Financial Officer

1	Accounting and Auditing Act
2	Anti-Deficiency Act
3	Budget and Accounting Procedures Act
4	Chief Financial Officers Act
5	Federal Financial Management Improvement Act
6	Federal Managers' Financial Integrity Act
7	Government Management Reform Act
8	Government Performance and Results Act
9	Prompt Payment Act

### Laws and Regulations Identified and Tested by Arthur Andersen

For the FY 1998 audit, Arthur Andersen considered the following laws and regulations as having a potential direct and material effect on the financial statements. Arthur Andersen tested for NASA compliance accordingly. Because the tests disclosed no reportable noncompliance, Arthur Andersen is not required to list the laws and regulations it tested in the report.

1	Anti-Deficiency Act
2	Departments of Veterans Affairs, Housing and Urban Development, and Independent Agencies Appropriations Act, 1998
3	Budget and Accounting Procedures Act of 1950
4	Chief Financial Officers Act of 1990
5	Debt Collection Act of 1982, 1990, and 1996
6	Federal Employees' Compensation Act
7	Federal Employees' Group Life Insurance Act of 1980
8	Federal Employees' Health Benefits Act of 1959
9	Federal Financial Management Improvement Act of 1996
10	Federal Managers' Financial Integrity Act of 1982
11	NASA Space Act of 1958
12	National Defense Authorization Act for Fiscal Year 1991 (Closed Account Legislation)
13	Pay and Allowance System for Civilian Employees: Civil Service Reform Act of 1978, Civil Service Retirement Act of 1930, Fair Labor Standards Act of 1938
14	Prompt Payment Act
15	Single Audit Act of 1984 and Single Audit Act Amendments of 1996

## Appendix D. Management's Response

National Aeronautics and  
Space Administration  
**Headquarters**  
Washington, DC 20546-0001



SEP 14 1999

Reply to Attn of: BF

TO: W/Assistant Inspector General for Auditing  
FROM: BF/Director Financial Management Division  
SUBJECT: July 16, 1999, Draft Report on the Audit of Selected Internal Controls  
Related to Financial Statement Audits

This is to provide comments on the subject draft report as amended through discussions with Van Tran of your staff on September 14, 1999.

### Recommendation for Corrective Action

1. **The Chief Financial Officer should annually coordinate with the external Auditor in identifying the laws and regulations that NASA considers to have a direct and material effect on the financial statements and that are the basis for the management representation letter.**

We concur with this recommendation and will meet with auditors on September 20, 1999.

### Recommendation for Corrective Action (as revised)

2. **The NASA Chief Financial Officer should provide timely, semi-annual status reports on the resolution and disposition of recommendations resulting from audits of financial statements.**

We concur with this recommendation as revised, and will provide status to the Inspector General and external audits by September 30, 1999, and include status in the annual Accountability Report.

We appreciate the cooperation we have received from Van Tran during this audit. If you have any questions please call me on 202-358-0978.

  
Stephen J. Varholy

cc:  
W/Mr. Van Tran  
JM/Mr. H. Robbins  
AA/Ms. A. Spivey

## **Appendix E. Report Distribution**

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House Committee on Appropriations  
House Subcommittee on VA, HUD, and Independent Agencies  
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**Congressional Member**

Honorable Pete Sessions, U.S. House of Representatives

## **Major Contributors to This Report**

Chester A. Sipsock, Director, Environmental and Financial Management Audits  
Van Tran, Auditor-in-Charge