

**QUALITY  
CONTROL  
REVIEW  
REPORT**

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**STROTHER & ASSOCIATES AUDIT OF  
NATIONAL AERONAUTICS AND SPACE  
ADMINISTRATION AMES RESEARCH CENTER  
EXCHANGE FINANCIAL STATEMENTS FOR  
FISCAL YEAR ENDED SEPTEMBER 30, 1998**

**September 11, 2000**

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National Aeronautics and  
Space Administration

**OFFICE OF INSPECTOR GENERAL**

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## **Acronyms**

AICPA	American Institute of Certified Public Accountants
CFO	Chief Financial Officer
FY	Fiscal Year
GAS	Government Auditing Standards
GAAS	Generally Accepted Auditing Standards

W

September 11, 2000

TO: A/Administrator

FROM: W/Inspector General

SUBJECT: INFORMATION: Quality Control Review of Audit of  
Ames Exchange Financial Statements  
Report Number IG-00-041

The NASA Office of Inspector General has completed a quality control review of the audit of the Ames Research Center Exchange financial statements for the fiscal year ended September 30, 1998. We found that Strother & Associates, the certified public accounting firm that performed the audit, omitted specific procedures required by generally accepted auditing standards (GAAS<sup>1</sup>) for assessing risk and planning the audit. In addition, the Ames Exchange contracted for the FY 1999 audit in accordance with GAAS, whereas NASA policy requires that Exchange audits for FY's 1999 and later be conducted according to government auditing standards (GAS). Finally, because the firm provides extensive nonaudit services to the Ames Exchange, financial statement users may have a perception that the firm lacks independence. As a result of the omitted audit procedures, use of inappropriate standards, and the perception of impaired independence, users may not fully rely on the Exchange's financial statements.

## **Background**

The Ames Exchange is a Government instrumentality, operating under NASA's control for the benefit of Agency employees. It operates and generates revenues primarily from a cafeteria, a gift shop, vending machines, mobile service trucks, and Space Camp.<sup>2</sup> For the year ended September 30, 1998, the Ames Exchange reported total cash of \$171,891<sup>3</sup> and net income of \$15,633.

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<sup>1</sup> Generally accepted auditing standards, promulgated by the American Institute of Certified Public Accountants, are broad statements of the auditors' responsibilities. The standards apply to audits of non-governmental organizations.

<sup>2</sup> Space Camp is a nonprofit facility that provides resident programs for children to promote interest in the wonders of science. The Ames Research Center provides onsite land and a range of services to the Space Camp Foundation.

<sup>3</sup> Cash equivalents include all highly liquid debt instruments purchased with a maturity of 3 months or less.

The Inspector General Act of 1978, as amended, requires Inspectors General to ensure that work performed by non-Federal auditors complies with GAS issued by the Comptroller General of the United States. The GAS incorporate, by reference, the GAAS for field work and reporting issued by the American Institute of Certified Public Accountants (AICPA). Compliance with GAS provides reasonable assurance that:

- Financial statements present fairly the financial condition and results of operations of the Exchange in accordance with established accounting principles.
- Internal controls are in place and operating as intended.
- The Exchange is complying with applicable laws and regulations.

In contrast to GAS, GAAS require an audit opinion<sup>4</sup> only on the financial statements and do not require reporting on internal controls or compliance with laws and regulations as part of the audit of the financial statements.

### **Recommendations**

We recommended that Strother & Associates revise its planning process for the FY 1998 audit of the Ames Exchange financial statements to comply with GAAS and that the Ames Exchange expand the audit of the FY 1999 financial statements to comply with GAS. We also recommended that subsequent financial statements audits be conducted in accordance with GAS. Finally, we recommended that the Ames Exchange engage an independent auditor to conduct audits of future financial statements.

### **Management Response**

NASA management and Strother & Associates concurred in the recommendations. Strother & Associates has revised its planning process for the FY 1998 audit of the Ames Exchange financial statements to comply with GAAS. The Exchange intends to expand the audit of the FY 1999 financial statements to comply with GAS and to require that subsequent financial statement audits be conducted in accordance with GAS. Also, the Ames Exchange will hire a bookkeeper/accounting clerk to process accounting transactions and engage an independent auditor to perform audits of the financial statements.

### **[Original signed by]**

Roberta L. Gross

Enclosure

Final Report on Quality Control Review of Strother & Associates Audit of the National Aeronautics and Space Administration Ames Research Center Exchange Financial Statements for Fiscal Year Ended September 30, 1998

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<sup>4</sup> GAAS require the auditor to provide an opinion on whether the financial statements are presented in conformity with generally accepted accounting principles.

**FINAL REPORT  
QUALITY CONTROL REVIEW OF  
STROTHER & ASSOCIATES AUDIT OF  
THE NATIONAL AERONAUTICS AND SPACE ADMINISTRATION AMES  
RESEARCH CENTER EXCHANGE FINANCIAL STATEMENTS FOR FISCAL  
YEAR ENDED SEPTEMBER 30, 1998**

W

September 11, 2000

TO: R/Associate Administrator for Aerospace Technology  
ARC/D/Director, Ames Research Center  
ARC/D/Chair, Ames Exchange Council

FROM: Assistant Inspector General for Auditing

SUBJECT: Final Report on Quality Control Review of Strother & Associates Audit  
of the National Aeronautics and Space Administration Ames Research Center  
Exchange Financial Statements for Fiscal Year Ended September 30, 1998  
Assignment Number A0002500  
Report Number IG-00-041

The subject final report is provided for your information and use. Please refer to the Executive Summary for the overall audit results. Our evaluation of your responses has been incorporated into the body of the report. The recommendations will remain open for reporting purposes until corrective action is completed. Please notify us when action has been completed on the recommendations, including the extent of testing performed to ensure corrective actions are effective.

If you have questions concerning the report, please contact Mr. Patrick Iler, Director, Audit Quality, at (216) 433-5408, or Ms. Bonnie Armstrong, Auditor-in-Charge, at (321) 867-4073. We appreciate the courtesies extended to the audit staff. The report distribution is in Appendix C.

Russell A. Rau

Enclosure

cc:

B/Chief Financial Officer  
B/Comptroller  
BF/Director, Financial Management Division  
G/General Counsel

Office of Inspector General

September 11, 2000

Mr. David Strother  
Strother & Associates  
Certified Public Accountant  
480 Saint John Street, Suite 120  
Pleasanton, CA 94566-6597

Re: Final Report on Quality Control Review of Strother & Associates Audit of the  
National Aeronautics and Space Administration Ames Research Center Exchange  
Financial Statements for Fiscal Year Ended September 30, 1998  
Assignment Number A0002500  
Report Number IG-00-041

Dear Mr. Strother:

The subject final report is provided for your information and use. Please refer to the Executive Summary for the overall audit results. Our evaluation of your responses has been incorporated into the body of the report. The recommendations will remain open for reporting purposes until corrective action is completed. Please notify us when action has been completed on the recommendations, including the extent of testing performed to ensure corrective actions are effective.

If you have questions concerning the report, please contact Mr. Patrick Iler, Director, Audit Quality, at (216) 433-5408, or Ms. Bonnie Armstrong, Auditor-in-Charge, at (321) 867-4073. We appreciate the courtesies extended to the audit staff. The report distribution is in Appendix C.

Sincerely,

**[Original signed by]**

Russell A. Rau

Enclosure

cc:

B/Chief Financial Officer

B/Comptroller

BF/Director, Financial Management Division

G/General Counsel

JM/Acting Director, Management Assessment Division

JR/Industrial Relations Officer

R/Associate Administrator for Aerospace Technology

ARC/D/Director, Ames Research Center

ARC/D/Chair, Ames Exchange Council

ARC/J/Exchange Operations Manager

ARC/DL/Chief Counsel

ARC/C/Chief Financial Officer



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# NASA Office of Inspector General

IG-00-041  
A0002500

September 11, 2000

## **Strother & Associates Audit of National Aeronautics and Space Administration Ames Research Center Exchange Financial Statements for Fiscal Year Ended September 30, 1998**

### **Executive Summary**

**Background.** The NASA Office of Inspector General performed a quality control review of the Strother & Associates audit of the Ames Research Center Exchange (Ames Exchange) fiscal year (FY) 1998 financial statements. Strother & Associates is a certified public accounting firm that has audited the Ames Exchange since 1992. The Ames Exchange is a Government instrumentality, operating under NASA's control for the benefit of Agency employees. It operates and generates revenues primarily from a cafeteria, a gift shop, vending machines, mobile service trucks, and Space Camp.<sup>5</sup> For the year ended September 30, 1998, the Ames Exchange reported total cash of \$171,891<sup>6</sup> and net income of \$15,633.

The Inspector General Act of 1978, as amended, requires Inspectors General to ensure that work performed by non-Federal auditors complies with GAS issued by the Comptroller General of the United States. The GAS incorporate, by reference, the GAAS<sup>7</sup> of field work and reporting issued by the AICPA. Compliance with GAS provides reasonable assurance that:

- Financial statements present fairly the financial condition and results of operations of the Exchange in accordance with established accounting principles.
- Internal controls are in place and operating as intended.
- The Exchange is complying with applicable laws and regulations.

In contrast to GAS, GAAS require an audit opinion<sup>8</sup> only on the financial statements and do not require reporting on internal controls or compliance with laws and regulations as part of the audit of the financial statements.

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<sup>5</sup> See footnote 2.

<sup>6</sup> See footnote 3.

<sup>7</sup> See footnote 1.

<sup>8</sup> See footnote 4.

**Objectives.** The objective of the quality control review was to ensure that the audit of the Ames Exchange financial statements was conducted in accordance with applicable auditing standards and to determine whether the Ames Exchange had taken corrective actions on recommendations resulting from the Strother & Associates audit. Appendix A contains additional details on our objectives, scope, and methodology.

**Results of Review.** Strother & Associates' process for updating audit programs and the Ames Exchange's communication process need improvement. Strother & Associates' audit report to the Ames Exchange expressed an unqualified<sup>9</sup> opinion on the fair presentation of the financial statements and stated that the audit was performed in accordance with GAAS. However, Strother & Associates omitted specific procedures required by GAAS for assessing risk during the audit planning phase (Finding A). Strother & Associates also omitted required procedures for performing analytical procedures (Finding B). In addition, the Ames Exchange contracted for the FY 1999 audit in accordance with GAAS, whereas NASA policy requires that Exchange audits for FY's 1999 and later be conducted according to GAS. Performing an audit in accordance with GAAS provides users of the financial statements no assurance about the effectiveness of an entity's internal controls or compliance with applicable laws and regulations (Finding C). Finally, because Strother & Associates provides extensive nonaudit services to the Ames Exchange, financial statements users may have a perception that the audit firm lacks independence (Finding D). As a result of the omitted audit procedures, use of inappropriate standards, and the perception of impaired independence, users may not fully rely on the Exchange's financial statements.

In addition to providing the audit report, Strother & Associates orally communicated recommendations for improvement to the Ames Exchange. The Ames Exchange has resolved all recommendations and implemented corrective actions where required. We consider actions taken by the Exchange to be responsive to the audit firm's recommendations.

**Recommendations.** We recommended that Strother & Associates revise its planning process for the FY 1998 audit of the Ames Exchange financial statements to comply with GAAS and that the Ames Exchange expand the audit of the FY 1999 financial statements to comply with GAS. We also recommended that subsequent financial statements audits be conducted in accordance with GAS. Finally, we recommended that the Ames Exchange engage an independent auditor that does not also provide extensive accounting services such as maintaining the official accounting records.

**Management's Response.** NASA management and Strother & Associates have agreed to implement all recommendations. Strother & Associates has revised its planning process for the FY 1998 audit of the Ames Exchange financial statements to comply with GAAS. The Ames Exchange intends to expand the audit of the FY 1999 financial statements to comply with GAS

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<sup>9</sup> An unqualified audit opinion means that the overall financial statements present fairly, in all material respects, the Ames Exchange's financial position and results of its operations and cash flow.

and to require that subsequent financial statements audits be conducted in accordance with GAS. The Ames Exchange will hire a bookkeeper/accounting clerk to process accounting transactions and will engage an independent auditor to perform audits of the financial statements.

**Evaluation of Management's Response.** The actions planned by NASA management and Strother & Associates are responsive to the recommendations. The recommendations are resolved but will remain undispositioned and open until agreed-to corrective actions are completed.

## Introduction

NASA Policy Directive 9050.6E, "NASA Exchange Activities," dated December 2, 1997, authorizes Center Directors to establish an Exchange to contribute to the efficiency, welfare, and morale of NASA personnel. Center Directors are required to appoint an Exchange Council to oversee and manage the Exchange operations in a sound, business-like manner. The Council must consist of at least five Center employees who perform their duties without pay from the Exchange. Council members serve as Chairperson, Treasurer, Exchange Operations Manager, and Secretary or in other advisory capacities. Exchange-operated activities are generally self-sustained, that is, supported by nonappropriated funds.<sup>10</sup> The Directive also requires the Council to obtain annual audits of the Center's Exchange financial statements and to submit the statements and the audit reports to the Center Chief Financial Officer (CFO) by December 31 annually.

Auditors engaged to conduct audits of Exchange financial statements have, for the most part, followed the GAAS issued by the AICPA. However, the NASA Inspector General, together with officials from the NASA Offices of the CFO and Management Systems, determined that the audits should be conducted in accordance with GAS because the Exchanges are Government instrumentalities. The Assistant Inspector General for Auditing issued a policy memorandum on March 1, 1999, to NASA Center Directors and Associate Administrators regarding the change to using GAS for Exchange financial statements audits beginning with the FY 1999 financial statements audits.

Strother & Associates, a small, certified public accounting firm, has performed the audit of the Ames Exchange financial statements since 1992. The firm also provides bookkeeping and advisory services and compiles the financial statements for the Ames Exchange.

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<sup>10</sup> Nonappropriated funds are funds received from sources other than congressional appropriations.

## **Findings and Recommendations**

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### **Finding A. Risk Assessments in Planning an Audit**

The audit of the Ames Exchange FY 1998 financial statements did not meet all requirements of GAAS. In planning the audit of the Ames Exchange FY 1998 financial statements, Strother & Associates omitted several required procedures related to considering internal controls and assessing the risk of fraud. Assessments of internal controls and fraud risk affect the nature, timing, and extent of substantive tests planned and performed. The audit firm omitted the procedures because it used an outdated audit program to conduct the audit and did not revise the audit program to include current standards. The reliability of the financial statements will be diminished if the audit firm performed insufficient tests on which to form an opinion as to whether the financial statements are presented in conformity with applicable accounting principles.

#### **Auditing Standards**

GAAS require that the auditor perform specific procedures in conducting an audit. For example, GAAS sections 319.03, 311.03, 316.12, and 319.57 require the auditor to obtain an understanding of the components of internal control; consider the planned, assessed level of control risk; assess the risk of material misstatement due to fraud; and document conclusions about the assessed level of control risk.

- **Internal Control Risk.** Components of internal control include risk assessment and information and communication. Risk assessment is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed. Information and communication involve the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities. GAAS section 319.03 requires that auditors assess control risk for the assertions<sup>11</sup> embodied in the account balance, transaction class, and disclosure components of the financial statements. The standard also requires that the auditor's conclusions about the assessed level of control risk be documented in working papers. The auditor uses the knowledge provided by the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.
- **Risk of Material Misstatement Due to Fraud.** The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. GAAS, section 316.12, requires the auditor to specifically assess the risk of material misstatement of the

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<sup>11</sup> Assertions are representations by management that are embodied in financial statement components. Assertions can be classified under five broad categories: existence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure. Assertions about existence address whether assets or liabilities exist at a given date.

financial statements due to fraud and to consider that assessment in designing the audit procedures to be performed. As part of the fraud risk assessment, the auditor should conduct inquiries of management (1) to obtain management's understanding regarding the risk of fraud in the entity and (2) to determine whether management has knowledge of fraud that had been perpetrated on or within the entity.

## **Required Audit Procedures**

Strother & Associates omitted required audit procedures because the firm performed the audit using an outdated audit program that had not been updated to include revisions to GAAS. The firm used a published audit program<sup>12</sup> to plan the audit and document audit procedures performed. Each year, the auditor updated information contained in the original audit program but did not update the audit program to include requirements resulting from changes to GAAS.

- **Consideration of Internal Controls.** Although Strother & Associates considered the Exchange's controls in planning the audit, the firm did not perform all required procedures in considering controls. Specifically, the firm did not obtain an understanding of the internal control components of risk assessment and information and communication. In addition, Strother & Associates did not document the basis for its conclusions about the assessed level of control risk.
- **Risk of Material Misstatement Due to Fraud.** Strother & Associates did not assess the risk of material misstatement due to fraud. Specifically, the firm did not make inquiries of the Ames Exchange to obtain management's understanding regarding the risk of fraud in the Exchange and to determine whether management had knowledge of fraud that had been perpetrated on or within the Exchange.

Strother & Associates updated the audit program for the FY 1999 audit.

## **Potential Effects**

Auditors use the knowledge obtained by assessing the level of control risk and fraud risk in determining the nature, timing, and extent of tests for financial statement assertions. Because Strother & Associates had not assessed risks, the sufficiency of audit tests and procedures is uncertain. As a result, users are not able to fully rely on the financial statements.

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<sup>12</sup> Strother & Associates used Practitioners Publishing Company's "Guide to Audits of Small Businesses" in determining which audit procedures to perform. The guide claims to (1) show auditors how to become more efficient without increasing the risk of underauditing; (2) provide a streamlined, yet technically sound audit approach that maximizes auditor flexibility; and (3) contain a complete set of audit programs, engagement correspondence, and checklists.

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

**We recommend that Strother & Associates perform omitted procedures to ensure that the FY 1998 audit meets all generally accepted auditing standards. Specifically, we recommend that Strother & Associates:**

- 1. Obtain an understanding of the internal control components of risk assessment and information and communication and document the planned assessed level of control risk.**
- 2. Assess the risk of material misstatement due to fraud to determine whether sufficient audit procedures were conducted to support conclusions, and document the assessment results.**
- 3. Design and perform additional audit tests and procedures if necessary.**

**Management's Response.** Concur. Strother & Associates will complete sections of the current audit program that were omitted from the obsolete version. The firm will use the updated sections to document fraud risk and the planned assessed level of control risk, evaluate the need for additional tests and procedures, and perform additional tests and procedures if necessary. The complete text of Strother & Associates' response is in Appendix B.

**Evaluation of Management's Response.** The actions planned by Strother & Associates are responsive to the recommendations. The recommendations are resolved but will remain undispositioned and open for reporting purposes until agreed-to actions are completed.



## **Finding B. Preliminary Analytical Procedures**

Strother & Associates did not perform preliminary analytical procedures in the planning stage of the Ames Exchange financial statements audit because the firm inappropriately considered these procedures to be unnecessary. The purpose of performing the analytical procedures early is to assist the auditor in planning the nature, timing, and extent of audit tests and procedures for financial statement assertions. If the firm had used the analytical procedures and identified specific risks relevant to the audit, the firm may have expanded audit tests and procedures. Users can not fully rely on the financial statements if the audit firm performed insufficient tests on which to form its audit opinion.

### **Auditing Standards**

GAAS 329.01 through 329.06 require the use of analytical procedures in the planning and overall review stages of all financial statements audits. The objective of analytical procedures is to identify, for example, the existence of unusual transactions and events, and amounts, ratios, and trends that could indicate matters that have financial statement and audit planning ramifications. Analytical procedures involve comparisons of recorded amounts (such as current period sales to prior period sales) or ratios developed from recorded amounts to expectations developed by the auditor. The auditor develops expectations from plausible relationships that exist among accounting data. Analytical procedures identify changes in expected relationships. If the auditor identifies unexpected changes in relationships, the auditor can determine the causes, such as unusual transactions, accounting changes, or misstatements. The analytical procedures should focus on (1) enhancing the auditor's understanding of the client's business, transactions, and events that have occurred since the last audit date and on (2) identifying areas that may represent specific risks relevant to the audit.

### **Audit Firm's History and Experience**

Strother & Associates has performed the audit of the Ames Exchange financial statements since 1992. In addition, the firm performs bookkeeping and advisory services for the Exchange. Because of the firm's history and experience with the Exchange, the auditor determined that preliminary analytical procedures were unnecessary. However, to comply with standards, auditors should apply, to some extent, preliminary analytical procedures to assist in planning the nature, timing and extent of auditing procedures, regardless of the auditor's history and experience with the entity.

### **Potential Effects**

If Strother & Associates had performed analytical procedures and identified specific risks, it may have expanded audit tests. If the firm performed insufficient tests on which to form an audit opinion, users are not able to fully rely on the financial statements.

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

**We recommend that Strother & Associates:**

**4. Perform preliminary analytical procedures for the FY 1998 audit, and determine whether auditors performed sufficient procedures during the audit to support conclusions.**

**5. Design and perform additional audit tests and procedures if necessary.**

**Management's Response.** Concur. Strother & Associates will compare selected amounts in the FY 1997 financial statements with corresponding unaudited amounts for FY 1998 and will perform additional audit procedures if determined necessary.

**Evaluation of Management's Response.** The actions planned by Strother & Associates are responsive to the recommendations. The recommendations are resolved but will remain undispositioned and open for reporting purposes until agreed-to actions are completed.

## **Finding C. Use of Generally Accepted Auditing Standards**

The Ames Exchange inappropriately contracted with Strother & Associates to perform the audit of its FY 1999 financial statements in accordance with GAAS.<sup>13</sup> The NASA March 1, 1999, policy requires the use of GAS for the FY 1999 audit. GAS require that auditors report on the effectiveness of an entity's internal controls and on compliance with applicable laws and regulations and that audit firms periodically undergo external peer reviews.<sup>14</sup> The Ames Exchange contracted for performance of the FY 1999 audit in accordance with GAAS because Exchange officials were not aware that the Exchange must specify appropriate audit standards when contracting for the audit. As a result, users of the financial statements have no assurance that the Ames Exchange's internal controls are effective and that the Exchange has complied with applicable laws and regulations.

### **Agency Policies and Procedures**

The March 1, 1999, policy memorandum from the Assistant Inspector General for Auditing to the NASA Center Directors and Associate Administrators states that because Exchanges are instrumentalities of the U.S. Government, audits of Exchange financial statements should be conducted in accordance with GAS. In addition, a November 17, 1999, letter from the Associate Administrator for Management Systems to NASA officials reinforces the requirement for audits of the Exchanges in accordance with GAS. The new requirement became effective beginning with the FY 1999 financial statements audits. Audits performed in accordance with GAAS require only an opinion on the fair presentation of the financial statements. However, audits conducted in accordance with GAS require reporting on the effectiveness of internal controls and compliance with laws and regulations, in addition to an opinion on the financial statements.

### **Applicable Standards**

Auditors engaged to conduct the financial audits of the Exchanges have, for the most part, followed GAAS. The Ames Exchange contracted for the FY 1998 audit to be conducted in accordance with GAAS. Following GAAS was appropriate because the contract predated the Inspector General policy memorandum on March 1, 1999.

**Generally Accepted Auditing Standards.** GAAS are categorized as general, field work, and reporting standards. General standards require auditors to have adequate training, maintain independence in mental attitude, and exercise due professional care in the performance of an audit. Field work standards require that auditors' work be adequately planned and supervised and that auditors obtain a sufficient understanding of internal controls and sufficient, competent evidence to form an opinion regarding the financial

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<sup>13</sup> We did not perform a quality control review of the FY 1999 financial statements audit.

<sup>14</sup> A peer review is the review, by certified public accountants, of a firm's compliance with its quality control system.

statements. Reporting standards require that auditors report whether financial statements are presented in accordance with generally accepted accounting principles, identify circumstances where principles were inconsistently applied, identify instances in which informative disclosures are inadequate, and express an opinion about the financial statements.

**Government Auditing Standards.** GAS are also categorized as general, field work, and reporting standards. However, in comparison to GAAS, GAS incorporate several additional standards. For example, GAS require auditors to design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements. In addition, GAS require that the audit report describe the scope and results of the auditor's testing of compliance with laws and regulations and internal controls. Finally, GAS require that each audit organization have an appropriate internal quality control system in place and undergo an external quality control review at least every 3 years.

### **Use of GAAS for the FY 1999 Audit**

The Ames Exchange inappropriately contracted with Strother & Associates to perform the FY 1999 financial statements audit in accordance with GAAS. GAAS require an audit opinion on the fair presentation of financial statements but do not require opinions on compliance with laws and regulations or internal controls. The FY 1999 audit should have been performed in accordance with GAS. The Exchange Financial Officer was unaware that Exchange audits must be conducted in accordance with GAS. She had not received a copy of the March 1, 1999, policy memorandum. Another Exchange official assumed that Strother & Associates followed appropriate standards, not realizing that the Exchange must request that the audit firm perform the audit in accordance with GAS.

If the audit had been conducted in accordance with GAS, the auditor would be required to report on compliance with laws and regulations and on internal controls. The report must describe the scope of the auditors' testing of compliance with laws and regulations and internal control and present the results of those tests. In presenting the results of those tests, auditors should report fraud, illegal acts, other noncompliance, and significant deficiencies in internal control over financial reporting.

In addition, if the audit had been conducted in accordance with GAS, the audit firm would be required to participate in peer reviews at least every 3 years.

**Monitoring Quality Control Policies and Procedures.** Strother & Associates is a small, certified public accounting firm that is not a member of the AICPA. The firm's quality control process did not detect procedures omitted from the planning phase of the audit program. The owner of the firm performed the audit of the Ames Exchange FY 1998 financial statements. Consequently, no higher level of management was available to supervise the audit work and review working papers.

Both GAAS and GAS require audit firms to establish quality control policies and procedures to provide them with reasonable assurance of conforming to applicable auditing standards. The nature and extent of a firm's quality control policies and procedures depend on such factors as the firm's size, the nature of its practice, its organization, and appropriate cost-benefit considerations. Monitoring procedures enable the firm to obtain reasonable assurance that its system of quality control is effective. Examples of monitoring procedures include review of working papers, reports, and clients' financial statements by a qualified management-level individual (or by a qualified individual under management's supervision). Small firms with a limited number of management-level individuals may find it beneficial to engage a qualified individual from outside the firm to perform monitoring procedures.

**Peer Review Process.** Successful completion of a peer review provides assurance that a firm's quality control process is operating effectively. Although both GAAS and GAS require audit firms to establish quality control policies and procedures, GAS require peer reviews every 3 years. GAAS require peer reviews only for AICPA member firms.

Certified public accountants perform a peer review to determine a firm's compliance with its quality control system. The purpose of a peer review is to determine and report on whether the firm under review has developed adequate policies and procedures for the elements of quality control and follows them in practice. Firms participating in peer reviews need to (1) establish and maintain appropriate quality control policies and procedures and comply with them, (2) have independent peer reviews of their accounting and auditing practices at least once every 3 years, and (3) take remedial, corrective actions as needed.

A peer review may substitute for some of a firm's monitoring procedures. For example, a firm could rely on a peer review to assist in (1) evaluating its quality control process instead of internally reviewing administrative and personnel records that pertain to quality control; (2) reviewing engagement working papers, reports, and clients' financial statements; and (3) discussing quality control with personnel.

Because Strother & Associates is not a member of the AICPA, the firm has not participated in a peer review process.

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

**We recommend that the Director, Ames Research Center, direct the Exchange to:**

**6. Procure for the FY 1999 financial statements additional audit services that conform to government auditing standards requirements for reporting on compliance with laws and regulations and internal control.**

**7. Require future annual audits of the Exchange to be performed in accordance with government auditing standards.**

**Management's Response.** Concur. The NASA Ames Exchange will engage a new accounting firm to perform the additional audit services for the FY 1999 financial statements that will meet GAS requirements and will require future annual audits to be performed in accordance with GAS. The Ames Exchange intends to contract with an appropriate accounting firm no later than December 31, 2000. The complete text of management's response is in Appendix B.

**Evaluation of Management's Response.** The actions planned by the Ames Exchange are responsive to the recommendations. However, to comply with NASA Policy Directive 9050.6E, the audited financial statements for FY 2000 must be submitted to the Center CFO by December 31, 2000. To meet the due date for submitting audited financial statements, the Exchange will need to expedite a contract for audit services. The recommendations are resolved but will remain undispositioned and open for reporting purposes until agreed-to actions are completed.

## **Finding D. Independence of Audit Firm**

Users of the Ames Exchange financial statements may not view Strother & Associates as an independent audit firm. The firm has a long relationship with the Ames Exchange and has performed bookkeeping, advisory, and audit services for the Exchange since 1992. Bookkeeping and advisory services included reconciling bank statements, posting transactions to the general ledger from journals provided by the Ames Exchange, issuing monthly compilation<sup>15</sup> reports, preparing annual financial statements, and assisting in establishing an appropriate list of accounts. The Ames Exchange has continued to use Strother & Associates for bookkeeping, advisory, and audit services because it values the firm's experience. However, users of financial statements must view the auditors' opinions, conclusions, judgments, and recommendations as independent in order to place reliance on the financial statements.

### **Auditing Standards**

If a certified public accountant records transactions in the journals for the client, posts monthly totals to the general ledger, makes adjusting entries, and subsequently does an audit, there is some question as to whether the accountant can be independent in his or her audit role. Both GAAS and GAS require auditors to be free from impairments to independence. Prior to FY 1999, the Exchange audits had been performed according to GAAS. However, current policy requires that audits of Exchange financial statements for FY's 1999 and later be conducted according to GAS because the Exchanges are Government instrumentalities.

- **GAAS Requirements.** GAAS require that in all matters relating to an audit assignment, independence in mental attitude must be maintained by the auditor. It is of the utmost importance to the audit profession that the general public maintain confidence in the independence of auditors. Public confidence might be impaired by the existence of circumstances that result in a perception of lack of independence. To be recognized as independent, the auditor must be free from any obligation to or interest in the client, its management, or its owners.

GAAS allow an audit firm to provide various services to clients. Audit firms may provide bookkeeping services and auditing services. However, an auditor's independence would be impaired if the auditor (1) determined or changed journal entries, account coding or classification for transactions, or other accounting records without obtaining client approval; (2) authorized or approved transactions;

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<sup>15</sup> Compilation means presenting, in the form of financial statements, information that is the representation of management without undertaking to express any assurance on the statements.

(3) prepared source documents<sup>16</sup> or created data; or (4) made changes to source documents without client approval.

GAAS require that the auditor consider the nature of nonaudit services that have been performed. The auditor should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit. We take no exception to the independence of Strother & Associates under these standards.

- **GAS Requirements.** GAS 3.11 require that in all matters relating to the audit work, the audit organization and the individual auditors be free from personal and external impairments to independence, be organizationally independent, and maintain an independent attitude and appearance.

Impairments to independence may include (1) professional relationships that might cause an auditor to limit the extent of the inquiry, to limit disclosure, or to weaken or slant audit findings in any way; (2) preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit; and (3) concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records. GAS 3.16 f. provides the following example of a situation in which an auditor's independence may be impaired.

For example, an individual performs a substantial part of the accounting process or cycle, such as analyzing, journalizing, posting, preparing, adjusting and closing entries, and preparing the financial statements, and later the same individual performs an audit. In instances in which the auditor acts as the main processor for transactions initiated by the audited entity, but the audited entity acknowledges responsibility for the financial records and financial statements, the independence of the auditor is not necessarily impaired.

The first part of the above example closely reflects the extent of services Strother & Associates provides to the Ames Exchange. Concerning the latter part of the example, Strother & Associates' services are more extensive than processing transactions initiated by the audited entity. Therefore, even if the Exchange acknowledges responsibility for the financial records and financial statements in its management representation letter, a perception of impaired independence exists. Strother & Associates cannot continue to perform the range of services, including audit services, and appear to be independent.

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<sup>16</sup> Source documents are the documents upon which evidence of an accounting transaction is initially recorded. Source documents are often followed by the creation of additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders.



## **Potential Impairments**

Independence in auditing means taking an unbiased viewpoint in performing audit tests, evaluating the results, and issuing the audit report. Independence must be regarded as the auditor's most critical characteristic. The reason that many users are willing to rely on the auditor's reports as to the fairness of financial statements is their expectation of an unbiased viewpoint. Strother & Associates reconciles Exchange bank statements, posts transactions to the general ledger from journals provided by the Exchange, issues monthly compilation reports, prepares annual financial statements, and assists in establishing an appropriate list of accounts. Strother & Associates has performed these services since 1992. GAAS permit audit firms to perform various services for clients, and Strother & Associates did not violate GAAS. However, third parties may view Strother & Associates' extensive involvement and long history with the Ames Exchange as an impairment to independence in the firm's audit of the Exchange's financial statements.

We learned that the Ames Exchange is deciding whether to perform accounting functions in-house instead of contracting with Strother & Associates for accounting services.

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

**8. We recommend that the Director, Ames Research Center, direct the Exchange to engage an auditor who does not also provide accounting services that constitute impairment of independence.**

**Management's Response.** Concur. The Ames Exchange will hire a bookkeeper/ accounting clerk to record accounting transactions and engage an independent auditor to perform future annual audits.

**Evaluation of Management's Response.** The actions planned by the Exchange are responsive to the recommendation. The recommendation is resolved but will remain undispositioned and open for reporting purposes until agreed-to actions are completed.

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

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### **Objectives**

The quality control review objective was to determine whether the audit work for the Ames Exchange was performed in accordance with applicable auditing standards. We also determined whether the Ames Exchange has taken corrective actions in response to recommendations resulting from the Strother & Associates audit.

### **Scope and Methodology**

In performing the quality control review of the Ames Exchange FY 1998 financial statements audit, we used an internal work program that incorporates GAAS issued by the AICPA and GAS issued by the Comptroller General of the United States. Based on those standards, we developed and organized the work program according to the general, field work, and reporting standards for financial audits. Our review focused on the auditors' qualifications, independence, peer review process, audit programs for appropriate procedures, and working paper documentation to include the results of the control risk assessment,<sup>17</sup> fraud risk assessment,<sup>18</sup> and controls testing. We also reviewed plans and actions taken by the Ames Exchange to implement the auditors' recommendations.

### **Management Controls Reviewed**

To meet the objective of this quality control review, we reviewed requirements of applicable auditing standards. GAAS are applicable to the FY 1998 audit. We compared the procedures Strother & Associates used during its FY 1998 audit of the Ames Exchange to those required by GAAS. GAS are applicable to the FY 1999 audit. The Ames Exchange should have requested that the FY 1999 audit be performed in accordance with GAS. We did not perform a quality control review of the FY 1999 audit. We considered management controls for the FY 1998 audit to be adequate except for the omitted audit procedures identified in Findings A and B.

To ensure the quality of its financial statements audits, Strother & Associates uses published audit programs, a process for supervisory review, a report referencing process, and continuing professional education. For the Ames Exchange audit, the firm used a published audit program that incorporates GAAS. To meet auditing standards for supervisory review, the firm's owner

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<sup>17</sup> AICPA Codification of Statements on Auditing Standards, Section 319, "Consideration of Internal Control in a Financial Statement," requires auditors to document the basis for concluding that control risk is below the maximum level.

<sup>18</sup> AICPA Codification of Statements on Auditing Standards, Section 316, "Fraud in a Financial Statement Audit," states that auditors are required to specifically assess the risk of material misstatement of the financial statements due to fraud and to document in the working papers evidence of its assessment.

generally reviews workpapers of auditors employed by the firm. However, in the case of the Ames Exchange audit, the firm's owner

## **Appendix A**

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performed the audit, and no higher level of supervision was available. In addition, the firm used a report referencing process to detect inconsistencies in the current report and between the current and prior years' reports. Finally, the firm's auditors conform to continuing professional education requirements established by the California Board of Accountancy. The Board's continuing professional education requirements correspond to GAS requirements.

### **Audit Field Work**

We performed the quality control review from January through May 2000.

## Appendix B. Management's Response

National Aeronautics and  
Space Administration  
**Ames Research Center**  
Moffett Field, CA 94035-1000



Reply to Attn of: J:241-11

AUG - 1 2000

TO: NASA Headquarters  
Attn: W/Assistant Inspector General for Auditing

FROM : J/Director of Center Operations

SUBJECT: Draft Report on Quality Control Review of Strother & Associates Audit of the NASA Ames Research Center Exchange Financial Statements for Fiscal Year Ended September 30, 1998

We have reviewed the June 29, 2000, Report and appreciate the opportunity to respond to Recommendations 6, 7, and 8.

**Recommendation 6.** Procure for the FY 1999 financial statements additional audit services that conform to government auditing standards requirements for reporting on compliance with laws and regulations and internal control.

**Response:** Concur. Since Strother & Associates has declined to perform future audits for the NASA Ames Exchange, we are currently trying to engage a new accounting firm to perform our annual financial audits according to GAS. When we find an appropriate firm, it is our intention to have them not only perform the FY 2000 financial audit, but to perform the additional audit services that will bring the FY 1999 audit into compliance with government auditing standards. We intend to complete the additional services to bring the FY 1999 financial audit into compliance with GAS no later than January 31, 2001.

**Recommendation 7.** Require future annual audits of the Exchange to be performed in accordance with government auditing standards.

**Response:** Concur. The Ames Exchange is currently searching for an accounting firm that is capable of performing audits according to GAS, as the former auditor, Strother & Associates, has declined to perform future audits for us. We intend to contract with an appropriate accounting firm no later than December 31, 2000. We will require all future annual audits to be performed in accordance with government auditing standards.

**Recommendation 8.** We recommend that the Center Director, Ames Research Center, direct the Exchange to engage an auditor who does not also provide accounting services that constitute impairment of independence.

**Response:** Concur. The Ames Exchange is in the process of hiring a bookkeeper/accounting clerk to work as an employee of the Exchange performing accounting services that were previously performed by Strother & Associates. The bookkeeper/accounting clerk will work on site at Ames and have no conflicting interests that would create a biased viewpoint. He/she will have no role in performing the annual audit of the Exchange businesses. We intend for all future annual audits to be performed totally independent of our internal accounting function. The Exchange expects to hire a bookkeeper/accountant no later than September 30, 2000.

J:241-11

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Should you have any questions regarding our response, please contact Katie Garcia at (650) 604-5669 or email to [kgarcia@mail.arc.nasa.gov](mailto:kgarcia@mail.arc.nasa.gov)

  
Jana M. Coleman

cc:  
NASA HQ  
R/S. Venneri  
RS/S. Humphrey  
JM/M. Myles  
  
KSC/W/B. Armstrong

## Appendix B

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*Strother & Associates, Certified Public Accountant*

480 Saint John Street, Suite 120  
Pleasanton, CA 94566-6597  
(925) 484-3000  
FAX (925) 484-3061

August 4, 2000

Mr. Russell A. Rau  
Office of Inspector General  
National Aeronautics and Space Administration  
**Headquarters**  
Washington, DC 20546-0001

Re: Draft Report on Quality Control Review of Strother & Associates Audit  
of the National Aeronautics and Space Administration Ames Research  
Center Exchange Financial Statements for Fiscal Year Ended September 30, 1998  
Assignment Number A0002500

Dear Mr. Rau:

The purpose of this letter is to respond to recommendations made in the above referenced report dated June 29, 2000. Specifically, we will respond to Findings A and B.

Finding A. Risk Assessments in Planning an Audit

We have reviewed the internal control audit programs that were used for the Fiscal Years Ended September 30, 1998 and 1999, and concur with your finding. In order to update the 1998 program to current standards we will complete those sections of the current program that were omitted in the obsolete version. Responding to questions in these missing sections will serve to document the planned assessed level of control risk along with the assessed risk of material statement due to fraud. After completion, we will determine whether additional audit tests and procedures would have been performed, and if determined necessary, will perform them.

Finding B. Preliminary Analytical Procedures

We concur with your finding and will perform preliminary analytical procedures for the Fiscal Year Ended September 30, 1998 by comparing selected amounts in the Fiscal Year Ended September 30, 1997 financial statements to unaudited amounts for the Fiscal Year Ended September 30, 1998. Once completed, a determination will be made as to whether additional audit procedures would have been performed, and if determined necessary, will perform them.

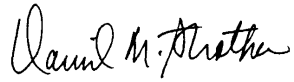
We plan to complete these report recommendations by Thursday, August 31, 2000.

August 7, 2000  
Mr. Russell A. Rau  
Office of Inspector General  
National Aeronautic and Space Administration  
Page Two

Please feel free to contact me if you have any questions.

Very truly yours,

**STROTHER & ASSOCIATES**  
Certified Public Accountant



David M. Strother

cc: Deborah Renick, Operations Manager  
NASA Exchange – Ames / Moffett

✓ Bonnie Armstrong  
NASA Office of Inspector General

## **Appendix C. Report Distribution**

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### **National Aeronautics and Space Administration (NASA) Headquarters**

A/Administrator  
AI/Associate Deputy Administrator  
B/Chief Financial Officer  
B/Comptroller  
BF/Director, Financial Management Division  
G/General Counsel  
J/Associate Administrator for Management Systems  
JM/Acting Director, Management Assessment Division  
JR/Industrial Relations Officer  
R/Associate Administrator for Aerospace Technology

### **NASA Centers**

Director, Ames Research Center  
Chair, Ames Exchange Council  
Chief Counsel, Ames Research Center  
Chief Financial Officer, Ames Research Center  
Ames Exchange Operations Manager  
Chief Counsel, John F. Kennedy Space Center

### **Non-NASA Federal Organizations and Individuals**

Assistant to the President for Science and Technology Policy  
Deputy Associate Director, Energy and Science Division, Office of Management and Budget  
Branch Chief, Science and Space Programs Branch, Energy and Science Division, Office of Management and Budget  
Associate Director, National Security and International Affairs Division, Defense Acquisitions Issues, General Accounting Office  
Professional Assistant, Senate Subcommittee on Science, Technology, and Space



**Chairman and Ranking Minority Member – Congressional Committees and Subcommittees**

Senate Committee on Appropriations

Senate Subcommittee on VA, HUD, and Independent Agencies

Senate Committee on Commerce, Science, and Transportation

Senate Subcommittee on Science, Technology, and Space

Senate Committee on Governmental Affairs

House Committee on Appropriations

House Subcommittee on VA, HUD, and Independent Agencies

House Committee on Government Reform

House Subcommittee on Government Management, Information, and Technology

House Subcommittee on National Security, Veterans Affairs, and International Relations

House Committee on Science

House Subcommittee on Space and Aeronautics, Committee on Science

**Congressional Member**

Honorable Pete Sessions, U.S. House of Representatives

## NASA Assistant Inspector General for Auditing Reader Survey

The NASA Office of Inspector General has a continuing interest in improving the usefulness of our reports. We wish to make our reports responsive to our customers' interests, consistent with our statutory responsibility. Could you help us by completing our reader survey? For your convenience, the questionnaire can be completed electronically through our homepage at <http://www.hq.nasa.gov/office/oig/hq/audits.html> or can be mailed to the Assistant Inspector General for Auditing; NASA Headquarters, Code W, Washington, DC 20546-0001.

**Report Title:** Quality Control Review of Strother & Associates Audit of the National Aeronautics and Space Administration Ames Research Center Exchange Financial Statements for Fiscal Year Ended September 30, 1998

**Report Number:** \_\_\_\_\_ **Report Date:** \_\_\_\_\_

*Circle the appropriate rating for the following statements.*

	Strongly Agree	Agree	Neutra l	Disagre e	Strongl y Disagre e	N/A
1. The report was clear, readable, and logically organized.	5	4	3	2	1	N/A
2. The report was concise and to the point.	5	4	3	2	1	N/A
3. We effectively communicated the audit objectives, scope, and methodology.	5	4	3	2	1	N/A
4. The report contained sufficient information to support the finding(s) in a balanced and objective manner.	5	4	3	2	1	N/A

*Overall, how would you rate the report?*

Excellent	Fair
Very Good	Poor
Good	

*If you have any additional comments or wish to elaborate on any of the above responses, please write them here. Use additional paper if necessary.* \_\_\_\_\_

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*How did you use the report?* \_\_\_\_\_

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*How could we improve our report?* \_\_\_\_\_

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*How would you identify yourself? (Select one)*

- |                     |  |
|---------------------|--|
| Congressional Staff | Media                                    |
| NASA Employee       | Public Interest                          |
| Private Citizen     | Other: _____                             |
| Government: _____   | Federal: _____ State: _____ Local: _____ |

*May we contact you about your comments?*

**Yes:** \_\_\_\_\_ **No:** \_\_\_\_\_

**Name:** \_\_\_\_\_

**Telephone:** \_\_\_\_\_

Thank you for your cooperation in completing this survey.

## **Major Contributors to the Report**

Patrick Iler, Director, Audit Quality

Bonnie Armstrong, Auditor-in-Charge

Nancy Cipolla, Report Process Manager

Annette Huffman, Program Assistant