


MEMORANDUM

Date: JUN 30 2003

To: Donna Fortunat
Division of Acquisition and Cost Support

From: 
Deborah H. Curéton
Associate Inspector General for Audit

Subject: Audit Report OIG 03-1010: Financial and Compliance Audit of Indirect Costs for the Year Ended June 30, 2000, for the Bishop Museum, Honolulu, Hawaii

Attached is the final "Financial and Compliance Audit of Indirect Costs for the Year Ended June 30, 2000" of the Bishop Museum. Your office had requested OIG to undertake an audit of the Museum's FY 2000 indirect cost rate proposal to facilitate negotiation of an indirect cost rate. NSF is currently the agency responsible for negotiating and approving indirect cost rates for Bishop Museum on behalf of the Federal government. As of June 30, 2000, Bishop Museum had six active NSF awards, for which it had received \$1 million in NSF funding; the unobligated balance was \$100,259.

The audit identified significant deficiencies in Bishop Museum's calculation of its indirect cost rate. Total audit adjustments necessary to correct the inaccuracies in the rate calculation amounted to \$534,929 in the indirect cost pool and \$285,546 in the direct cost base. As a result, there is a 5.32 percentage point reduction between the [REDACTED] percent proposed rate and the [REDACTED] audit-determined rate. As a result of the weaknesses in Bishop Museum's internal control processes for accounting and calculating its indirect cost rate, we estimate that the Federal Government will pay \$.6 million more in indirect costs over the next five years if the conditions noted in the audit report are not corrected in future indirect cost proposals.

The audit also identified significant weaknesses in Bishop Museum's processes for accounting for its indirect costs that if left unresolved could affect future indirect cost rates. In particular, due to lack of training, Bishop staff did not completely understand Federal regulations related to the preparation and submission of indirect cost proposals. In addition, the Museum did not have policies and procedures to segregate unallowable

costs, and did not maintain separate account codes in order to record unallowable expenses. To more equitably allocate indirect costs to agencies such as NSF, which primarily fund research, we concluded that in the future Bishop Museum should use a Multiple Allocation Base Method to compute its indirect cost rate, or compute a separate indirect cost rate for research.

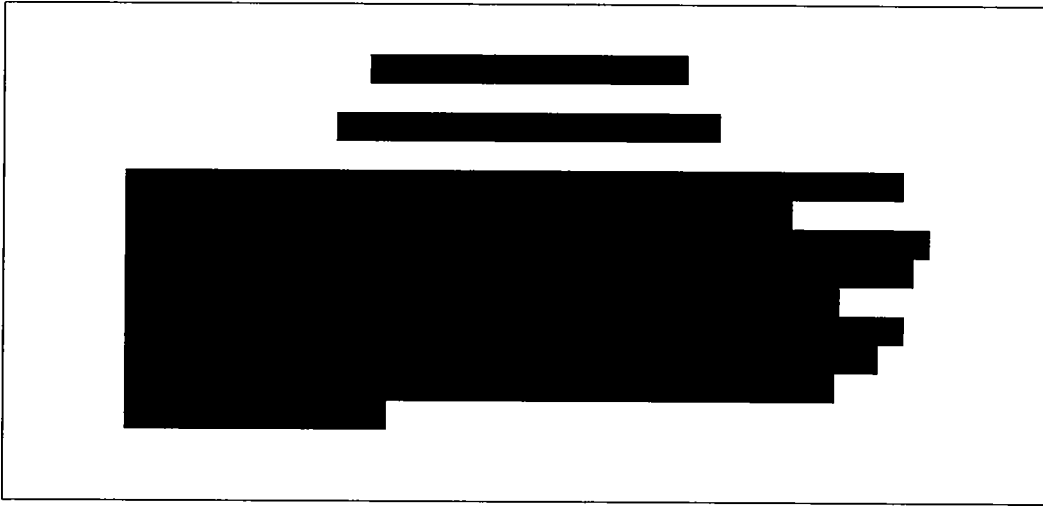
In response to the audit report, Bishop Museum has indicated that it will train its staff and prepare and implement policies and procedures for the preparation of future indirect cost proposals in compliance with Federal and NSF requirements. However, it disagreed with the recommendation to use a Multiple Allocation Base Method to calculate its indirect cost rate, because it thought the costs of doing so would exceed the benefits. Because we conclude that NSF is currently paying for Facility costs that do not benefit NSF awards, we reiterate our recommendation.

In accordance with OMB Circular *A-50, Audit Followup*, and NSF's *Standard Operating Guidance 2001-4, Policies and Procedures to Audit Reports Issuance and Resolution of Audit Findings Contained in Audits of NSF Awardees*, we request that NSF submit a corrective action plan to our office identifying the specific actions and milestone dates for addressing our recommendations.

We thank you and your staff for the cooperation extended to us during this audit. If you have any questions about this report, please contact James Noeth, on extension 5005, or Emily Woodruff, on extension 5019.

Bishop Museum
Honolulu, Hawaii

Financial and Compliance Audit
Of Indirect Costs
For the Year Ended
June 30, 2000



CONTENTS

	Page
Section I - Introduction and Audit Results:	
Background	2
Objective, Scope, and Methodology	2
Summary Results of Audit	4
Exit Conference	6
Section II -- Findings and Recommendations:	
Findings and Recommendations on Internal Control	8
Findings and Recommendations on Compliance	11
Other Matters	15
Section III - Financial Schedules:	
Schedule A Summary Schedule Indirect Cost Rates	19
Schedule B Schedule of Indirect Pool Costs	20
Schedule C-1 Schedule of Adjustments to the Direct Cost Base	25
Schedule C-2 Adjustments to Allocation Base	26
Schedule C-3 Voluntarily Deleted Unallowable Activity Expenses, Which Should Have Been Included in the Base	27
Schedule D Schedule of Contracted Services	29
Schedule E Schedule of Excess Fringe Benefits and Associated Overhead	32
Schedule F Schedule of Excess Currency Charges on Award No. DEB-9707928	33
Appendix: Bishop Museum Responses to Draft Audit Report	34

ACRONYMS

The following acronyms are used in this report.

DACS	NSF Division of Acquisition and Cost Support
DGA	NSF Division of Grants and Agreements
FCTR	Federal Cash Transactions Report
FY	Fiscal Year
NSF	National Science Foundation
OIG	NSF Office of the Inspector General
OMB	U.S. Office of Management and Budget

SECTION I

INTRODUCTION AND AUDIT RESULTS

Introduction and Audit Results

Background

Bishop Museum, a not-for-profit-organization located in Honolulu Hawaii, is a natural and cultural history museum founded in 1889 to honor the memory of Princess Bernice Pauahi Bishop, the last descendent of the Kamehameha royal family. The Museum is organized into seven program areas: Information Resources, Collections Management, Research, Consulting, Public Programs, Merchandising, and Hawaii Maritime Center. Federal agencies fund programs in three of these areas, Collections Management, Research, and Public Programs. As of the one-year period ending June 30, 2000, Bishop Museum had about \$12 million total expenditures, \$4 million of which were expenses for Federal awards. Of these Federal expenses, NSF awards constituted approximately \$200,000, about 5 percent. At the end of Bishop Museum's June 30, 2000 Fiscal Year (FY), NSF had six open awards. According to the Federal Cash Transactions Report as of the same date, the cumulative total NSF had disbursed on these awards was \$1,046,492 and the unobligated balance was \$100,259.

NSF has acted for several years as the cognizant agency for negotiating and approving indirect costs rates on behalf of all Federal agencies.² The NSF Cost Analysis and Audit Resolution Branch requested the Office of the Inspector General (OIG) to conduct an audit of Bishop Museum's indirect costs to facilitate negotiation of an indirect cost rate. The last indirect cost rate for Federal awards negotiated by Bishop and NSF, effective from 7/1/97 until amended, was a predetermined rate of [REDACTED] percent.

Objective, Scope, and Methodology

We conducted a financial and compliance audit of Bishop Museum's FY 2000 indirect cost proposal in order to determine final indirect cost rate for that year and to assist NSF in determining whether Bishop Museum had a reliable methodology and process for proposing future indirect cost rates. Our audit objectives were to determine

¹ NSF awards included: OCE-9415948, DEB-9527915, DEB-9528025, DEB-9705494, EAR-706033, and DEB-9707928.

² OMB Circular A- 122, *Cost Principles for Non-Profit Organizations*, Attachment A, Section E 1 a. OMB Circular A- 122, Attachment A, Section E 2 a states:

Unless different arrangements are agreed to by the agencies concerned, the Federal agency with the largest dollar value of awards with an organization will be designated as the cognizant agency for the negotiation and approval of the indirect cost rates.... Once an agency is assigned cognizance for a particular non-profit organization, the assignment will not be changed unless there is a major long-term shift in the dollar volume of the Federal awards to the organization.

whether Bishop Museum complied with Federal requirements in computing its indirect cost proposal and to evaluate the adequacy of Bishop Museum's internal controls to administer, account for, and monitor indirect cost charges to Federal awards.

The audit scope included a review of Bishop Museum's proposed FY 2000 indirect cost rate to determine whether the rate was based on reasonable, allocable, and allowable costs, and whether Bishop Museum had adequate controls to administer, account for, and monitor indirect costs in accordance with Federal cost principles and administrative requirements. We tested Bishop Museum's compliance with Federal requirements and the adequacy of its internal controls. Specifically, we audited costs included in the indirect cost pool and in the direct cost base by testing a sample of transactions in the pool and the base and by reviewing the Museum's timekeeping system. We were on site from April 13, 2001 to April 24, 2001. Subsequently, we requested and obtained additional documentation from the Museum to support its proposal.

We conducted our review in accordance with the Comptroller General's Government Auditing Standards, and accordingly included such tests of accounting records and other auditing procedures that we considered necessary to address the review objectives.

Museum Response

We provided Bishop Museum with a draft of this report to allow officials the opportunity to review the report and provide written responses to the findings and recommendations. We summarized Bishop Museum's responses, which follow each recommendation. The complete written response is included in the Appendix to this audit report. We revised our report where appropriate, based on the Museum's responses.

Summary Results of Audit

Bishop Museum proposed an indirect cost rate of [REDACTED] percent for FY 2000, but our audit determined that the actual rate is [REDACTED] percent. Based on Federal requirements, we questioned \$534,929 of the \$4 million of costs in Bishop's indirect cost pool.³ We also found that the Museum overstated its \$7.4 million direct cost base by \$557,385 because it included the full value of subcontracts,⁴ even though the NSF-negotiated indirect cost agreement required the Museum to include only the first \$25,000 per contract. In addition, we added \$271,839 of expenses that benefited from the Museum's indirect costs to the direct cost base.⁵ Combined, these adjustments decreased the direct cost base by \$285,546 to \$7.1 million. Projecting the 5.32 percent difference between the audited and proposed rates into the future, we estimate that using the audited rate instead of the higher proposed rate would save the Federal Government \$.6 million over a five-year period.⁶ Our audit also found that Bishop Museum did not have adequate controls to account for and monitor indirect costs in accordance with Federal cost principles and administrative requirements. Specifically, we noted a material internal control weakness, a reportable condition that is not a material weakness, and three compliance deficiencies, which collectively resulted in Bishop Museum's overstated indirect cost rate.

Contrary to Federal requirements, Bishop Museum included unallowable costs from seven financial accounts in its indirect cost pool, mistakenly omitted 10 activities from its direct cost base, included excessive subcontract costs in that base, and did not adequately document its valuation for voluntary service costs added to the base. These errors occurred primarily because the Bishop Museum staff responsible for proposing an indirect cost rate did not fully understand the applicable Federal administrative requirements and cost principles. This lack of understanding was manifested in so many facets of our audit that we have concluded that Bishop Museum has a systemic internal control weakness in the systems, policies, and procedures it uses to prepare indirect cost proposals.

In addition, Bishop Museum's allocation of indirect costs may not be equitable. Federal requirements state that if an organization's indirect costs benefit its major functions to approximately the same degree, it may allocate indirect costs by a simplified method; and alternatively, if its indirect costs benefit its major functions in varying degrees, it would more accurately allocate indirect costs by a multiple allocation base method. Bishop Museum uses the simplified method and thus calculates only one indirect cost rate. However, since the Museum has many program areas/functions, this allocation of indirect costs may not be equitable. For example, NSF funds primarily Research Programs; but although many of the Museum's facilities, such as the Planetarium, benefit Public Programs not Research Programs, these large Public Program

³ See Schedule B.

⁴ See Schedule D.

⁵ See Schedule C-1.

⁶ See Schedule A.

facility costs are incorporated into the single indirect cost rate. Thus, the Museum's use of a single rate may cause NSF and other Federal agencies that generally fund Research Programs to pay a disproportionate share of the Museum's indirect costs. Bishop does not separate Facilities from Administrative costs because it does not receive more than \$10 million in Federal funding, the threshold at which the cost principles require a separate rate for each of these costs.

We also questioned \$46,326 of direct costs, of which \$40,440 were excessive recoveries of fringe benefits and \$5,886 were overcharges on program costs that required currency exchange reconciliation.

To address the internal control weakness and compliance deficiencies, we recommend that the Directors of NSF's Division of Acquisition and Cost Support (DACS) and Division of Grants and Agreements (DGA) require that the Bishop Museum develop policies and procedures for preparing indirect cost rate proposals and train its staff to prepare indirect cost proposals that comply with Federal requirements. In addition, we recommend that if Bishop receives future NSF awards, the Directors should require the Museum to break out research as a function so that NSF does not pay for excessive Facility costs when it reimburses Bishop's indirect costs on NSF awards. We also recommend that the Directors require that Bishop Museum repay \$46,326 of excessive direct and indirect costs to the Federal Government.

EXIT CONFERENCE

An exit telephone conference was conducted on January 8, 2003. The findings on compliance and internal control and the adjustments to the indirect cost proposal were discussed. The following participated in the telephone conference:

For Bishop Museum:



For the NSF Office of the Inspector General

James Noeth, Senior Audit Manager

Bandana Sen, Auditor

Emily Woodruff, Attorney Advisor

SECTION II

FINDINGS AND RECOMMENDATIONS

**Findings and Recommendations on Internal Control
For the Year ended June 30, 2000**

Material Weakness

The Office of Management and Budget (OMB) has promulgated administrative requirements and cost principles for recipients of Federal funds to follow in accounting for, documenting, and reporting indirect costs on Federal awards. The cost principles for non-profits, OMB Circular A- 122, consist of complex rules regarding the allowability of costs, the composition of the direct cost base, and various methods to use in proposing an indirect cost rate. The Bishop Museum's FY 2000 indirect cost proposal reflected a lack of understanding of these cost principles. Specifically, the Museum included unallowable costs in the indirect cost pool; omitted certain costs, which should have been included in the direct cost base; and did not support its valuation of voluntary service costs with actual costs paid for regular employees for comparable volunteer work.

In addition, the Museum submitted its FY 2000 indirect cost proposal based on total direct costs, not modified total direct costs, the method stipulated in prior negotiated rates, resulting in an inflated direct cost base. Netting costs that Bishop Museum mistakenly included in its direct cost base from the costs that should have been included in the base, we subtracted a total of \$285,546 from the direct cost base.⁵ As a combined result of overstating the indirect cost pool and the direct cost base, the Museum overstated the proposed indirect cost rate by 5.32 percentage points. The errors occurred because the Bishop Museum accounting staff, like that of many non-profits, is small, responsible for multiple tasks, and did not have adequate training to prepare the indirect cost proposal.⁹ In addition, the Museum did not develop adequate written policies and procedures to prepare indirect cost rate proposals.

Recommendation

We recommend that the Directors of NSF's Division of DACS and DGA require that Bishop Museum 1) develop written policies and procedures for preparing indirect cost proposals; and 2) train its accounting staff so that it develops sufficient expertise to prepare future indirect cost rate proposals that comply with all applicable Federal requirements, and 3) support its voluntary service costs with actual costs paid to regular employees for comparable volunteer work.

¹ Modified total direct costs are total direct costs excluding capital expenditures, participant support, and subcontract costs exceeding \$25,000.

⁸ Additions to the direct cost base	\$271,839	See Schedule C-1.
Subtractions from the direct cost base	<u>(\$557,385)</u>	See Schedule D.
Net reduction to the direct cost base	(\$285,546)	

⁹ Non-profits traditionally have small, over-burdened accounting staffs, in contrast to larger organizations, where specific tasks, such as preparing an indirect cost proposal, might be handled by staff who become experts in this limited area.

Museum's Response

Bishop Museum agreed with the first two parts of this recommendation. Subsequent to its review of the draft audit report, the Museum also sent us a list of actual FY 2002 costs for volunteer service positions, and stated that the costs for FY 2000 were comparable.

OIG's Comment

No further response is necessary.

Reportable Condition (Non-Material Weakness)

OMB Circular A-122, Attachment A, Section D 1 (b) states:

Where an organization has several major functions which benefit from its indirect cost in varying degrees, allocation of indirect costs may require the accumulation of such costs into separate cost groupings which then are allocated individually to benefiting functions by means of a base that best measures the relative degree of benefit.

OMB Circular A-122, Attachment A, Section D 5 states:

When a particular segment of work ...[under a single award or . . . under a group of awards....] is performed in an environment which appears to generate a significantly different level of indirect costs, provisions should be made for a separate indirect cost pool applicable to such work.

To compute its indirect cost rate, Bishop Museum uses the simplified method, which combines all allowable indirect costs into one pool and divides that pool by a direct cost base. However, Bishop has seven program areas, one of which is research, the area which NSF traditionally funds at the Museum. The NSF awards do not use the Planetarium or areas of the Museum where artifacts such as spears are stored. Nevertheless, because the costs for these facilities are included in the Museum's indirect cost pool, NSF pays a portion of these facility costs when it reimburses its indirect costs on specific NSF awards. We believe that the Museum's Public Program facility costs are greater than its Research Program facility costs and therefore, that NSF may be paying a disproportional amount of indirect costs for its research awards to Bishop. The Museum has not computed an indirect cost rate by breaking research indirect costs into separate groupings, nor has it computed a special indirect cost rate for research, because it thinks the costs of these approach are too high and unnecessary.

Recommendation

We recommend that if NSF makes future research awards to Bishop, the Directors of NSF's Divisions of DACS and DGA require the Museum to calculate indirect costs for research, either through the multiple allocation base method or by the computation of a special indirect cost rate.

Museum's Response

The costs to implement a multiple allocation base will exceed the benefits. OMB Circular A- 122 states that the simplified allocation method may be used when an organization's major functions benefit from its indirect costs to approximately the same degree, which is the case for Bishop Museum. Also, the Museum does not receive more than \$10 million in Federal funding of direct costs and is therefore not required by OMB Circular A-122 to break out Facilities and Administrative costs. Further, a majority of the costs in the indirect cost pool are administrative and would be allocable on a standard modified direct cost basis, and therefore, there would be insignificant differences in indirect costs allocated to discrete program areas. Finally, during the last negotiation of the indirect cost rate with NSF, NSF requested that Bishop use the simplified allocation method.

OIG's Comment

Although we agree that Bishop Museum is not required to break out Facilities and Administrative costs because it receives less than \$10 million a year in Federal funds, we disagree that its major functions benefit from its indirect costs to approximately the same degree. To the contrary, we believe that the Museum has "several major functions which benefit from its indirect costs in varying degrees."¹⁰ Therefore, we conclude that Bishop Museum should apportion indirect costs by accumulating them into separate cost groupings, allocate them individually to benefiting functions by means of a base which best measures the relative degree of benefit, and then distribute the indirect costs allocated to each function to individual awards by means of indirect cost rate. NSF proposed the simplified allocation method during the last indirect cost rate negotiation because that negotiation was based on a desk review, not an on-site visit and an audit. During our site visit to the Museum and audit of Bishop's FY 2000 indirect cost rate proposal, we found that NSF is reimbursing Bishop Museum for more than NSF's fair share of indirect costs on NSF awards because NSF only funds research functions, but the indirect cost rate is based on indirect costs for seven functions and includes facility costs for buildings NSF awards do not use. Thus, we reiterate our recommendation that if NSF makes future awards to Bishop Museum the Directors of NSF's DACS and DGA should require Bishop to calculate indirect costs specifically for research, either through the use of the multiple allocation base method or by means of calculating a special indirect cost rate.

¹⁰ OMB Circular A-122, Attachment A, Section D 1 b.

Findings and Recommendations on Compliance For the Year ended June 30, 2000

1. Unallowable Costs in the Indirect Cost Pool

According to the applicable cost principles, certain costs are unallowable as charges to the Federal Government. Bishop Museum's indirect cost pool included the following specific costs, which are disallowed by these cost principles:

- **OMB** Circular A-122, Attachment B, Paragraph 40 b states that gains or losses from the sale or exchange of property are unallowable. Bishop Museum included \$209,121 of costs associated with the loss on the sale of property in the indirect cost pool.
- **OMB** Circular A- 122, Attachment B, paragraph 11 c (2) states that depreciation will exclude the portion of the cost of buildings and equipment borne by the Federal Government. Bishop Museum included \$134,886 of depreciation costs for Government-funded assets in its indirect cost pool.
- OMB Circular A-122, Attachment B, paragraph 23 c states that costs of investment counsel incurred to enhance income from investments are not allowable. Bishop Museum included \$107,268 of unallowable investment property expenses in its indirect cost pool.
- OMB Circular A- 122, Attachment B, paragraph 23 b states that fundraising costs are unallowable. Bishop Museum included \$46,128 of "Legal and Accounting" costs," and \$6,538 of "Other Contracted Services" costs, both of which were fundraising costs, in its indirect cost pool.
- **OMB** Circular A- 122, Attachment B, paragraph 1, states that advertising costs are unallowable. Due to an accounting error, Bishop Museum failed to exclude \$27,940 of advertising costs from its indirect cost pool.
- OMB Circular A- 122, Attachment B, paragraph 14 states that entertainment costs are not allowable. Bishop Museum included \$3,048 of unallowable entertainment costs in its indirect cost pool.

As a result of the inclusion of unallowable costs in its indirect cost pool, Bishop Museum overstated the pool by \$534,929, and thus overstated its proposed indirect cost rate. The Museum included unallowable costs in its indirect cost pool because it does not have any written policies and procedures to define and segregate unallowable costs and does not maintain separate account codes to record unallowable expenses. In addition, Bishop Museum does not have separate accounts to record assets purchased by Government funds to ensure that the depreciation of these assets is not included in the indirect cost

¹¹ Of the questioned \$46,128 of Legal and Accounting costs in the pool, \$40,094 were questioned because they were double-counted, not because they were unallowable under the cost principles.

pool. Also, Bishop Museum did not understand the Federal cost principles requiring it to net investment losses from revenue generated by the investment property.

Recommendation

We recommend that the Directors of NSF's DACS and DGA require Bishop Museum to develop and implement written policies and procedures to segregate unallowable costs, and to maintain separate account codes in order to record unallowable expenses, including codes to segregate assets purchased by Government funds from other assets.

Museum's Response

Bishop Museum generally agreed with our recommendation to improve policies and procedures to segregate unallowable costs, and to maintain separate account codes to record unallowable expenses, including codes to segregate assets purchased with Government funds from assets acquired with other revenue sources. However, Bishop Museum objected to the draft report recommendation to net a portion of the revenues from Public Programs from the costs in the indirect cost pools, which we had done to compensate for the inclusion of the sizeable amount of costs from Public Program facilities NSF awards do not utilize. The Museum also stated that \$40,094 of the \$46,128 of questioned legal and accounting costs was not unallowable but double-counted, and that \$2,232 of the \$5,280 of questioned entertainment costs was allowable employee morale expense.

OIG's Comment

Although we still believe that netting of a portion of Public Program revenues from the indirect cost pool would result in a more accurate apportionment of indirect costs associated with Research Programs, we have omitted netting in this report because the applicable cost principles do not explicitly authorize netting program income. Instead, we have addressed the issue of inequitable allocation of indirect costs prospectively in our recommendations on internal control. However, we agree with Bishop Museum's response to our identifying a portion of legal and accounting and entertainment expenses as questioned costs and have revised the audit report accordingly.

2. Other Direct Cost Base Adjustments

OMB Circular A-122, Attachment A, Section A 2, states that to be allowable under an award, costs must be reasonable and allocable to the awards, and conform to exclusions in other sections of A-122. However, although unallocable or unallowable costs cannot be charged to the Federal Government, they must be treated as direct costs in the direct cost base used to calculate the indirect cost rate under certain circumstances.

Specifically, OMB Circular A-122, Attachment A, section B 3 states:

The cost of certain activities are not allowable as charges to Federal awards. . . However, even though these costs are unallowable for purposes of computing charges to Federal awards, they nonetheless must be treated as direct costs for the purposes of determining indirect cost rates and be allocated their share of the organization's indirect costs if they represent activities which (1) include the salaries of personnel, (2) occupy space, and (3) benefit from the organization's indirect costs.

Bishop Museum understated its direct cost base by \$271,839 because it did not include unallocable costs, such as rental property expenses, or unallowable costs, such as entertainment and fundraising costs, in its direct cost base. It did not do so because Bishop accounting staff overlooked the Federal requirement that certain activity costs that are unallowable as indirect costs should nevertheless be included in the direct cost base. As a result of the exclusion of these costs from the direct cost base, Bishop Museum understated the direct cost base and overstated the indirect cost rate.

Recommendation

We recommend that the Directors of NSF's Divisions of DACS and DGA ensure that Bishop Museum add to its direct cost base unallocable and unallowable activity costs that represent activities that include the salaries of personnel, occupy space, and benefit from the organization's indirect costs.

Museum's Response

Bishop Museum replied that \$240,000 of the costs added to the base should not have been included because they represented an in-kind contribution that involved minimal support and oversight by Museum staff.

OIG's Comment

We have deleted the \$240,000 of in-kind costs from the direct cost base. No further response is necessary.

3. Use of Incorrect Direct Cost Base

When it negotiated its last indirect cost rate agreement for the Federal Government with Bishop Museum, NSF stated that the Museum's rate was based on modified total direct costs (MTDC), which includes only the first \$25,000 of subcontract costs. Bishop Museum overstated its direct cost base by \$557,385 because it did not deduct any subcontract costs. Bishop did not use MTDC as its base for calculating its indirect cost rate because it overlooked this requirement in its negotiated rate agreement.

Recommendation

We recommend that the directors of NSF's DACS and DGA require Bishop Museum to use the modified total direct cost base required by agreements negotiated with NSF as its base for calculating proposed indirect cost rates.

Museum's Response

Bishop Museum agreed with this recommendation.

OIG's Comment

No further response is necessary.

Other Matters

In our audit of the six open NSF awards, we found that in FY 2000 Bishop Museum had claimed a total of \$46,326 excessive direct costs for fringe benefits and program costs that required currency exchanges. We also found that the independent CPA firm that performed the single annual audit of Bishop Museum for FY 2000, as required by OMB Circular A-133,¹² issued a Management Letter, which noted seven accounting issues for which the Museum needed to take corrective action.

1. Over-Recovery of Fringe Benefits and Associated Indirect Costs

OMB Circular A-122, Attachment B, paragraph 7 f (1) states that fringe benefit costs are allowable, provided that such costs are charged on the basis of actual costs. Bishop Museum billed fringe benefits and associated indirect costs as direct costs to the Federal Government using its estimated fringe benefit rate of [REDACTED] percent, although the Museum calculated that its actual fringe benefit rate was [REDACTED] percent.¹³ Thus, for FY 2000, the Museum over-billed the Federal Government for \$40,440 on Federal awards. Bishop over-billed the Federal Government because it said that it used a fixed with carry forward method to adjust fringe benefits in future years.

Recommendation

We recommend that the NSF Divisions of DACS and DGA require Bishop to return \$40,440 to the Federal Treasury.

Museum's Response

Bishop Museum stated that it uses the fixed with carry forward provision provided for in OMB Circular A-122 and would adjust the \$40,440 in rates for future periods.

OIG's Comment

The fixed with carry forward provision in OMB Circular A- 122 applies to overhead rates, not to fringe benefit costs. The applicable fringe benefit provisions in OMB Circular A-122 state that fringe benefits shall be charged on the basis of actual costs. However, Bishop is proposing to use the actual rates from one year as the basis for the calculation of the next year's rates. We reiterate our recommendation.

¹² OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

¹³ We did not audit this rate.

2. Currency-Exchange Rates Too High

OMB Circular A-122, Attachment A, Section A 2 states that to be allowable, costs must be reasonable and allocable to an award. Bishop Museum made \$42,000 of advances to researchers working in Papua New Guinea on award No. DEB-9707928, and included the \$42,000 as part of the costs that NSF reimbursed. The advances were based on costs previously incurred in Papua New Guinea Kina. According to the conversion rates used on these advances, Bishop Museum over-recovered \$5,886 on the exchanges between U.S. Dollars and the Kina. The over-recoveries occurred because Bishop staff intended to reconcile the exchanges from U.S. Dollars to expenses recorded in Kina only at the expiration of the award.

Recommendation

We recommend that the Directors of NSF's DACS and DGA require Bishop Museum to repay NSF for the \$5,886 of over-charges on Award No. DEB-9707928.

Museum's Response

Bishop Museum objected to our use of historical exchange rates to convert U.S. dollars to Kina and subsequently provided us with actual exchange rates used by its bank on the dates of the conversion.

OIG's Comment

Our recommendation for the repayment of \$5,886 now represents the actual amount of overcharges, using the incurred costs reported in Kina, the advance amounts in U.S. dollars, and the bank rates on the dates of the exchanges.

3. Prior Audit Findings

Ernst and Young's Management Letter of 3/21/01, issued in accordance with its FY 2000 A-133 audit of Bishop Museum disclosed the following:

- Need to enforce current procedures to ensure timely preparation and review of payroll reconciliation.
- Need to ensure that Unconditional Promises to Give and Contributions Received are recorded on a timely basis.
- Need to develop a formal process to evaluate long-lived assets (particularly investment properties) in compliance with FASB Statement 121.
- Need to ensure timely submission of performance reports and FCTRs.
- Need to enforce procurement policy by requiring appropriate documentation for all items greater than \$2,500.

¹⁴ See Schedule F.

- Need to revise bids and quotations policy to state explicitly the requirements of OMB Circular A-110, Subpart C, paragraph 44 (a), which states that "All recipients shall establish written procurement procedures... that provide... that (1) Recipients avoid purchasing unnecessary items. (2) Where appropriate, an analysis is made of lease and purchase alternatives to determine which would be the most economical and practical procurement for the Federal Government. (3) Solicitations for goods and services provide for [six listed requirements]."
- Need to maintain written documentation regarding sub-recipient monitoring.

Recommendation

We recommend that the Directors of NSF's Divisions of DACS and DGA verify whether Bishop Museum has addressed all seven issues listed above, and if it has not, to take appropriate action to ensure that the Museum does adequately implement steps to address these management letter findings.

Museum's Response

Bishop Museum states that it has addressed most of the recommendations in prior audit findings and that it is in the process of reviewing policies and procedures regarding the remaining finding, the evaluation of long-lived assets.

OIG's Comment

We reiterate our recommendation, and specifically recommend that NSF review the policies and procedures Bishop has developed for procurement, bids and quotations, subrecipient monitoring, documentation of unconditional promised to give and contributions received, and the evaluation of long-lived assets.

SECTION III
FINANCIAL SCHEDULES

Bishop Museum
Audit of Indirect Cost Rate Proposal
For FY 2000 (ended June 30, 2000)
Summary

PROPOSED AND AUDITED INDIRECT COST RATES

	Proposed	Audited	Schedule Reference
Indirect Costs	██████████	██████████	B
Total Direct Costs	██████████	██████████	C-1
Modified Total Direct Costs	██████████	██████████	C-1
Indirect Cost Rate	██████████	██████████	

PROJECTED COST SAVINGS TO THE FEDERAL GOVERNMENT
(Funds Put To Better Use)

Total Modified Direct Costs	
On All Federal Awards	██████████
Indirect Costs at ██████%	██████████
Indirect Costs at ██████%	██████████
Cost Savings	<u><u>\$ 118,991</u></u>
Cost Savings For 3 Years	<u><u>\$ 356,972</u></u>
Cost Savings For 5 Years	<u><u>\$ 594,954</u></u>

NOTE:

The amount of FY 2000 modified total direct costs for the six NSF awards open as of the end of FY 2000 is \$128,417. Thus, NSF's portion of the total is 5.7% (██████████).

Award Number	Claimed Modified Total Direct Costs
DEB-9528025	\$ 1,678
DEB-9707928	46,014
EAR-9706603	773
DEB-9527915	24,093
DEB-9705494	29,937
OCE-9415948	25,921
TOTAL \$	<u><u>128,417</u></u>

**Bishop Museum
Indirect Cost Pool
Fiscal Year ended June 30, 2000**

Cost Elements	General Ledger¹⁵	Voluntarily Excluded	Claimed Overhead	Questioned	Audited Overhead	Notes to Schedule B
		\$ 0		\$ 0		
		0		0		
		0		0		
		(22,631)		(27,940)		Note 1
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		(6,538)		Note 2
		0		0		
		0		0		
		0		(134,886)		Note 3
		0		0		
		(12,872)		0		
		0		0		
		0		(3,048)		Note 4
		0		0		
		(27,469)		0		
		(538)		0		
		(49,810)		0		
		0		0		
		0		0		
		0		0		
		(37,100)		0		
		0		(46,128)		Note 5
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		(7,900)		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		0		0		
		(241)		0		
		0		0		
		0		0		
		<u>\$ (158,561)</u>		<u>\$ (218,540)</u>		
		0		0		
		0		(209,121)		Note 6
		0		<u>(107,268)</u>		Note 7
		<u>\$ (158,561)</u>		<u>\$ (534,929)</u>		

¹⁵ The General Ledger amount for Bank Charges is net of \$() for a prior year adjustment.

¹⁶ Adjustment made by Ernst & Young

**Bishop Museum
Notes to Schedule B**

Note 1- Advertising

OMB Circular A- 122, Attachment B, paragraph 1 states that advertising costs are unallowable. Due to an accounting error, Bishop Museum failed to exclude \$27,940 of advertising costs.

OMB Circular A-122, Attachment A, Section B 1 states that direct costs "are those that can be identified specifically with a particular final cost objective" Bishop Museum included \$37,473 of promotional costs for its Native Hawaiian Culture and Arts Program in its indirect cost pool, although they are direct costs identified with this program.

<u>Account Number</u>	<u>Department</u>	<u>Amount</u>
[REDACTED]	[REDACTED]	[REDACTED]
	Subtotal	\$50,571
	Bishop Voluntarily Excluded	<u>22,631</u>
	Total Questioned Costs	<u>\$27,940</u>

Note 2 – Other Contracted Services

OMB Circular A-122, Attachment B, paragraph 23 b states that fundraising costs are unallowable. Per the Vice President and Treasurer of Bishop Museum, these contracted service costs were for fundraising and revenue generation.

<u>Account Number</u>	<u>Department</u>	<u>Description</u>	<u>Amount</u>
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
		Total Questioned Costs	<u>\$6,538</u>

Note 3 - Depreciation

OMB Circular A- 122, Attachment B, paragraph 11 c (2) states that computation of depreciation will exclude: "Any portion of the cost of buildings and equipment borne by or donated by the Federal Government. ..." Bishop Museum included depreciation of \$134,886 on government-funded assets in the indirect cost pool.

<u>Asset Acquired in Fiscal Year</u>	<u>FY 2000 Depreciation</u>
1964	[REDACTED]
1994	[REDACTED]
1995	[REDACTED]
1996	[REDACTED]
1997	[REDACTED]
1998	[REDACTED]
1999	[REDACTED]
2000	[REDACTED]
Total Questioned Costs	<u>\$134,886</u>

**Bishop Museum
Notes to Schedule B (Continued)**

Note 4 - Entertainment Services

OMB Circular A-122, Attachment B, paragraph 14 states that in general entertainment costs are not allowable.

	<u>Date</u>	<u>Amount</u>
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
Subtotal -	[REDACTED]	\$1,870
[REDACTED]	[REDACTED]	[REDACTED]
Subtotal -	[REDACTED]	\$34
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
Subtotal -	[REDACTED]	\$1,143
Total Questioned Costs		\$3,048

Bishop Museum
Notes to Schedule B (Continued)

Note 5 - Legal and Accounting

OMB Circular A-122, Attachment B, paragraph 23 b, states "Costs of... Expenses incurred solely to raise capital or obtain contributions are unallowable." OMB Circular A-122, Attachment B, paragraph 23 c, states: "Costs of investment counsel and staff and similar expenses incurred solely to enhance income from investments are unallowable." Bishop Museum claimed \$6,034 of unallowable legal and accounting (but not Ernst and Young) costs: \$4,685 to obtain funding from the Bishop Trust, and \$1,349 for management of the museum's properties.

OMB Circular A- 110, Section 21 (b) (1) states that recipients of Federal funds shall have financial management systems that provide accurate financial records. Bishop Museum included \$40,094 of excess charges in its Legal and Accounting accounts, in part because it counted fees to Ernst and Young both as accruals and when paid.

Unallowable Legal and Professional (not Ernst and Young)	<u>Date</u>	<u>Amount</u>
Subtotal - Unallowable Legal and Professional		\$6,034
Excessive Legal, Professional, and Accounting		
Total Claimed		
Legal and Professional Services		
Booked and Accrued Accounting Expenses		
Total Invoiced Accounting Expenses		
Subtotal – Excessive Legal, Professional, and Accounting		\$ 40,094
Total Questioned Costs		\$46,128

Note 6 - Loss on Sale of Property

OMB Circular A-122, Attachment B, paragraph 40, b states: "Gains or losses... arising from the sale or exchange of property ... shall be excluded in computing award costs."

Bishop Museum included \$209,121 of costs associated with loss on the sale of property in the overhead pool. As a result, the overhead pool and overhead rate were overstated. The inclusion of \$209,121 in the overhead pool for loss on the sale of property occurred because Bishop's CPA auditor, Ernst & Young, made an overhead pool adjustment of \$209,121 for impairment loss related to one of the museum's investment properties (FY 2000, A-133 Audit Report, p.13).

Bishop Museum
Notes to Schedule B (Continued)

Note 7 - Investment Property Expenses

OMB Circular A-122, Attachment B, paragraph 23 c states: Costs... incurred solely to enhance income from investments are not allowable." The following expenses are unallowable:

[REDACTED]	Subtotal	[REDACTED]	\$ 13,575
[REDACTED]	Subtotal	[REDACTED]	19,495
[REDACTED]	Subtotal	[REDACTED]	1,226
[REDACTED]	Subtotal	[REDACTED]	3,675
[REDACTED]	Subtotal	[REDACTED]	46,210
[REDACTED]	Subtotal	[REDACTED]	<u>50,553</u>
Total [REDACTED]			\$134,734
Less: Interest Charges Voluntarily Deducted			<u>(27,466)</u>
Total Questioned [REDACTED]			<u>\$107,268</u>

**Bishop Museum
Adjustments to the Direct-Cost Base
FY 2000 (Ending June 30, 2000)**

Total Direct Costs Adjustment

<u>Program</u>	<u>Direct Expenses</u>	<u>Per Proposal</u>	<u>Notes</u>
████████████████████		██████████	
████████████████████		██████████	
██████████		██████████	
██████████		██████████	
██████████		██████████	
████████████████████		██████████	
████████████████████		██████████	
████████████████████		██████████	
	TOTAL	<u>\$7,363,353</u>	
<u>Additions to Direct Cost Base</u>		<u>Per Audit</u>	
	Questioned Activity Costs	\$150,828	See Schedule C-2
	Unallowable Activity Expenses	121,011	See Schedule C-2
	Total Adjustments	<u>\$271,839</u>	
	Audit Determined Total Direct Costs	<u>\$7,635,192</u>	

Adjustment from Total Direct Costs to Modified Total Direct Costs

<u>Direct Expenses</u>	<u>Per Audit</u>	<u>Notes</u>
Total Direct Costs (Adjusted)	\$7,635,192	
Subcontract Costs Adjustment	(557,385)	See Schedule D
Modified Total Direct Costs	<u>\$7,077,807</u>	

**Bishop Museum
Adjustments to the Allocation Base**

OMB Circular A-122, Attachment B, paragraph 23 d states: "Fundraising and investment activities shall be allocated an appropriate share of indirect costs under the conditions described in **subparagraph B.3 of Attachment A.**"

OMB Circular A-122, Attachment A, section B 3 states: "The costs of certain activities are not allowable as charges to Federal awards ... However, even though these cost are unallowable for purposes of computing charges to Federal awards, they nonetheless must be treated as direct costs for purposes of determining indirect cost rates and be allocated their share of the organization's direct costs if they represent activities which (1) include the salaries of personnel, (2) occupy space, and (3) benefit from the organization's indirect costs."

I. Unallowable Activities, Which Should Have Been Included in the Base

Of the \$534,929 of unallowable indirect cost expenses deducted from the indirect cost pool (see Schedule B), the following costs should be allocated to the direct cost base because they were incurred to generate revenue and/or benefit from the organization's indirect costs.

		See Note 7 to Schedule B See Note 5 to Schedule B See Note 1 to Schedule B See Note 4 to Schedule B See Note 2 to Schedule B
TOTAL SECTION I	<u>\$150,828</u>	

II. Voluntarily Deleted Unallowable Activity Expenses, Which Should Have Been Included in the Base

The following costs were direct-activity costs that were unallowable, but which constitute functions and activities which should incur their fair shares of indirect costs.

		See Schedule C-3 See Schedule C-3 See Schedule C-3 See Schedule C-3 See Schedule C-3 See Schedule C-3
TOTAL SECTION II	<u>\$121,011</u>	

TOTAL ADJUSTMENTS TO DIRECT COST BASE	\$271,839
(Section I + Section II)	

**Bishop Museum
Voluntarily Deleted Unallowable Activity Expenses,
Which Should Have Been Included In The Base**

OMB Circular A- 122, Attachment A, Section B 3 states that certain unallowable costs, such as fundraising, should be treated as direct costs for purposes of determining indirect cost rates. Bishop Museum deleted these costs but did not add them back to the base. Thus, the following advertising costs (costs used to raise revenues) are added back to the direct cost base.

<u>Advertising</u>	<u>Cash</u>	<u>In-Kind</u>	<u>Total</u>
[REDACTED]			
Note: Advertising was misstated; and according to a correction received on 11/26/2002, the actual account totals are as follows:			
[REDACTED]	[REDACTED]	\$ [REDACTED]	[REDACTED]
		0	
		0	
		0	
Subtotal	\$81,727	\$27,940	\$109,667

Previously added back		<u>(27,940)</u>	Schedule C-2
Total Addition to Direct Cost Base		<u>\$ 81,727</u>	

OMB Circular A- 122, Attachment B, paragraph 14 states that "[c]osts of amusement, diversion, social activities, ceremonials, and costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities are unallowable."

OMB Circular A-122, Attachment A, paragraph B 3 states: "The cost of certain activities are not allowable as charges to Federal awards... However ... they must be treated as direct costs for purposes of determining indirect cost rates and be allocated their share of the organization's indirect costs if they represent activities which (1) include the salaries of personnel, (2) occupy space, and (3) benefit from the organization's indirect costs."

**Bishop Museum
Voluntarily Deleted Unallowable Activity Expenses,
Which Should Have Been Included In The Base**

Bishop Museum voluntarily deleted the following costs, but did not add them to the direct cost base.

[REDACTED]	Program	Amount
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
	Total	\$10,724

[REDACTED]	Account	Amount
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
	Total	\$ 749

[REDACTED]	Program	Amount
[REDACTED]	[REDACTED]	\$ [REDACTED]
	Total	\$20,522

[REDACTED]	Program	Amount
[REDACTED]	[REDACTED]	\$ [REDACTED]
	Total	\$ 6,089

[REDACTED]	Program	Amount
[REDACTED]	[REDACTED]	\$ [REDACTED]
	Total	\$ 1,200

Bishop Museum
Schedule of Contracted Services
For Fiscal Year Ended June 30, 2000

Vendor Number	Vendor	Related to a Federal Program?	Funding Agency	Total Contract Amount	FY 96 – FY 99 Expenditures	FY 00 Expenditures	Excluded from O/H Base**
[REDACTED]	[REDACTED]	No	N/A	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
		No	N/A	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
		No	N/A	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
		Total Non-Federal Subawards		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
		Total Federal and Non-Federal Subawards		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

* These vendors were paid for services rendered but there were no contracts.

** To compute Overhead Rate for Modified Total Direct Costs, Subawards > \$25,000 at the beginning of the subaward period are excluded from Overhead Allocation Base. The subaward costs of \$[REDACTED] are excluded from the Overhead Allocation Base.

**Bishop Museum
Excess Currency Charges
on Award Number
DEB-9707928**

Provider/Recipient	Date	Amount	Questioned Cost	Remarks
[REDACTED]	[REDACTED]	[REDACTED]	\$ 3,006	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	1,673	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	3,192	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	4,059	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	(1,296)	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	(4,748)	[REDACTED]
Total Questioned Costs			\$ 5,886	

BISHOP MUSEUM
Honolulu, Hawaii
Responses to Draft Audit Report
Received March 8, 2003
Recommendations as stated in Audit Report
Auditee's Response: Verbatim Response from Bishop Museum

Internal Control Finding

Material Weakness

Recommendation

We recommend that the Directors of NSF's Division of DACS and DGA require that Bishop Museum 1) develop written policies and procedures for preparing indirect cost proposals; and 2) train its accounting staff so that it develops sufficient expertise to prepare future indirect cost rate proposals that comply with all applicable Federal requirements, especially those in OMB Circular A-122.

Auditee's Response

Bishop Museum will plan to document its indirect cost proposal policies and procedures and use this opportunity to train its staff on preparing future indirect cost rate proposals in compliance with OMB Circular A-122.

Compliance Findings

Finding 1: Unallowable Costs

Recommendation 1

We recommend that the Directors of NSF's DACS and DGA require Bishop Museum to develop and implement written policies and procedures to segregate unallowable costs, and to maintain separate account codes in order to record unallowable expenses, including codes to segregate assets purchased by government funds from other assets.

Auditee's Response

In general, we agree with the recommendations on improving policies and procedures for unallowable costs and developing separate account codes for recording unallowable expenses. However, we take exception to two of the items cited in this finding of the audit report.

Item 1: Bishop Museum included \$46,128 of Legal and Accounting costs as fundraising cost in its indirect cost proposal.

The \$46,128 of Legal and Accounting expenses include an amount of \$40,094 related to double recording for accounting related services, an otherwise allowable indirect expense.

Item 2. Bishop Museum included \$5,280 of unallowable entertainment costs in its indirect cost pool.

OMB Circular A-122 does provide that costs incurred to promote employee morale, health and welfare are allowable. The majority of the entertainment costs cited by the auditor were related to Museum sponsored activities and intended to improve employer and employee relationships, employee morale, and overall employee performance. This amount totaled \$2,232.

Finding 2: Indirect Cost Rate for Research Overstated

Recommendation2

We recommend that the Directors of DACS and DGA require Bishop Museum to net a portion of revenues from its indirect cost pool, by either using an approach like the one used in this audit, or by using a Multiple Allocation Base Method, as described next.

Auditee's Response

We do not understand the basis of the auditors' finding. The indirect cost proposal is based on an indirect cost rate that takes into account the total cost of operations. The cost for supporting programs relating to information services and the general public were included in the program direct cost base of the indirect cost proposal and, therefore, an equitable allocation of administration and facility costs was already included in the indirect cost proposal. The arbitrary reduction of the indirect cost pool by netting fees from program revenue would serve to understate the actual calculation of indirect costs used to support the overall activities of the Museum. Netting revenue against the indirect cost pool and not adjusting the direct program costs results in a distortion of the indirect cost rate calculation for the Museum's overall program operations.

Furthermore, the auditors have cited OMB Circular A- 122, Attachment A, paragraph 5, related to applicable credits. In accordance with the Circular, the credits typically relate to purchase discounts, rebates, or allowances, recoveries or indemnities on losses, insurance refunds, and adjustments of overpayments or erroneous charges. In our opinion, information service fees and Museum admission proceeds do not meet the criteria of applicable credits as stated in OMB Circular A-122.

Finding 3: Use of Inappropriate Allocation Method

Recommendation3

We recommend that the Directors of NSF's Divisions of DACS and DGA require Bishop Museum to evaluate the use of the Multiple Allocation Base Method for calculating its indirect cost rate proposals to facilitate negotiation of indirect cost rates per program area.

Auditee's Response

We do not agree with this audit recommendation. We believe that the costs to implement a multiple allocation base will exceed the benefits in terms of data gathering and staff time. In addition, according to OMB Circular A- 122, Attachment A, section D, paragraph 2, the Simplified Allocation Method may be used when an organization's major functions benefit from its indirect costs to approximately the same degree, which is applicable to Bishop Museum. In addition, Bishop Museum does not receive more than \$10 million in Federal funding of direct costs in a fiscal year and is not required to break out the indirect cost component into Facilities and Administration categories as stated in OMB Circular A- 122, Attachment A, paragraph 2 e. Furthermore, a majority of the cost included in the indirect cost pool is administrative in nature and would, therefore, be allocable on a standard modified direct cost basis. Given this fact, there would be insignificant differences in indirect costs allocated to discrete program areas.

For additional clarification, we take exception to the auditors' statement that revenue received should be subtracted from programs in which revenue is received. As a result, the auditors have not supported their position that Bishop Museum disproportionately allocated indirect costs to each program by following the Simplified Allocation Method provided for in OMB Circular A- 122.

Finally, when the Museum last negotiated the indirect cost rate with NSF, it is our understanding that the Simplified Allocation Method was requested and agreed to, over the Multiple Allocation Base Method.

Finding 4: Voluntary Services in Direct Cost Base Understated

Recommendation4

We recommend that the Directors of NSF's Divisions of DACS and DGA ensure that Bishop Museum values its voluntary services labor at hourly rates that include inflation adjustments.

Auditee's Response

We do not agree with this finding to apply a CPI factor to that labor rate. Based on the current labor market for similar work in other activities of the organization, the current labor market is \$10 per hour and represents the fair market value of donated services. The \$10 per hour labor rate is more than reasonable given the current economic climate in labor markets experienced in Hawaii.

Finding 5: Other Direct Cost Base Adjustments

Recommendation 5

We recommend that the Directors of NSF's Divisions of DACS and DGA ensure that Bishop Museum add to in its direct cost base unallowable activity costs that represent activities that include the salaries of personnel, occupy space, and benefit from the organization's indirect costs.

Auditee's Response

We question the auditors' adjustment to increase the direct cost base by \$514,071. Specifically, this amount included a \$240,000 in-kind contribution by placing Bishop Museum's name in a free publication circulated in Hawaii. This is a free publication that required minimal support and oversight by Bishop Museum staff. As indicated by the auditors, the nature of this in-kind contribution did not consume salaries of personnel, occupy space, or require any significant support of the organization's indirect costs. Accordingly, at a minimum, \$240,000 of the \$514,071 should be excluded as a direct cost adjustment for the purposes of determining the indirect cost rate.

Finding 6: Use of Incorrect Direct Cost Base

Recommendation 6

We recommend that the directors of NSF's DACS and DGA requires Bishop Museum to use the modified total direct cost base required by agreements negotiated with NSF as its base for calculating proposed indirect cost rates.

Auditee's Response

We agree with the recommendation and will implement a separate expense code for capturing subcontractor costs in excess of \$25,000 for use in developing the modified total direct cost base for indirect cost rate purposes.

Other Matters

Finding 1: Over-Recovery of Fringe Benefits and Associated Indirect Costs

Recommendation 1

We recommend that the NSF Divisions of DACS and DGA require Bishop Museum to return \$40,440 excess fringe benefits and associated indirect costs to the Federal Treasury.

Auditee's Response

The standard practice by Bishop Museum is to use an estimated Fringe Benefit rate for the period, and subsequently calculating the actual rate for the fiscal period and carrying forward any adjustments to future periods for developing future Fringe Benefit rates. In essence, the Bishop Museum is following the fixed with carry forward provision as provided for in OMB Circular A-

122 to account for its Fringe Benefit costs. Accordingly, the \$40,440 excess fringe benefits determined by the auditors will be adjusted in Fringe Benefit rates for future periods.

Finding 2: Current-Exchange Rates Too High

Recommendation 2:

We recommend that the Directors of NSF's DACS and DGA determine if Bishop Museum adjusted for the currency exchange discrepancies at the end of the award, currently listed in NSF records as 9/30/01; and if not, require Bishop Museum to repay NSF for the \$6,318 of over-charges due to inaccurate currency conversions. We also recommend that the Directors require Bishop Museum to develop written policies and procedures for currency conversions on awards with expenses recorded in foreign currencies.

Auditee's Response

Based upon follow up discussions with the Museum staff involved, the conversion rate used to convert U.S. dollars to PNG Kina was the actual rate obtained from the bank when the currency was exchanged. Exchange rates change daily and are almost always less than the rates listed in the newspapers and currency conversion websites; the reason being that many newspapers and websites list the interbank rate, which is the best rate that can be obtained among banks. The difference between the rates given over the counter at a bank and the interbank rate could be up to, and sometimes greater than, 10%. We have no control over the conversion rates that we receive from the bank. The effective rate that we receive, less any fees, can be substantiated by Kina based bank statements. Given the documentation that was provided, we disagree with this finding by the auditors.

Finding 3: Over-Recovery of Indirect Costs

Recommendation 3:

We recommend that Directors require Bishop Museum to repay NSF \$4,371 of excess indirect costs claimed in FY 2000.

Auditee's Response

We disagree with the auditors' claim that there was an excessive indirect cost rate. The basis for the claim is predicated on their adjusted 40.93 percent rate as stated in this report. As noted throughout our response to this report, we question a number of adjustments and interpretations of OMB Circular A-122 cited by the auditors. In fact, we question the revenue adjustment made to the indirect cost pool for revenue received from information service activities and Museum admissions while the total costs to support these activities are still included in the direct cost base. In addition, \$240,000 of in-kind advertising in a free publication circulated in Hawaii does not require significant indirect cost support on behalf of the Museum. The reversal of these two adjustments to the auditors' proposed rate results in a revised indirect cost rate of 49.5 percent.

Adjusted Indirect Cost Rate:
 $\$3,538,085 (\$3,022,259 + \$515,826) / 7,144,263 (\$7,384,263 - \$240,000) = 49.5$ percent

Finding 4: Prior Audit Findings

Recommendation 4:

We recommend that the Directors of NSF's Divisions of DACS and DGA verify whether Bishop Museum has addressed all seven issues listed above, and if it has not, to take appropriate action to ensure that the Museum does adequately implement steps to address these management letter findings.

Auditee's Response

- **Payroll Reconciliations** - The lag in performing reconciliations was a result of the changeover in personnel responsible for preparing payroll information. This problem has been corrected and the new individual has been trained to properly perform this responsibility, and is currently completing the reconciliations on a timely basis.
- **Documentation of Unconditional Promises to Give and Contributions Received** - The Development Department has developed a formal process to ensure that:
 1. Sufficient evidence is maintained.
 2. Pledges and contributions received are recorded on a timely basis. A new Development system has been implemented which makes this process much easier. The old system was a manual process.
- **Evaluation of Long-Lived Assets** - The Museum is in the process of reviewing all of its policies and procedures, including the policy governing investment properties. The Chief Financial Officer reviews the values of its real estate holdings at least annually, and other investments at least quarterly. As part of the annual review, a formal evaluation will be completed and documented.
- **Timely Submission of Reports to Federal Agencies:**
 1. Performance Reports - It is the responsibility of the principal investigator to file performance reports on a timely basis. The Museum has recently hired a new staff person whose primary responsibility is to assist in managing the larger Federal grants and completing reports to the Federal agencies, including NASA. We anticipate that this will allow the Museum to file reports on a timely basis.
 2. Federal Cash Transaction Reports - The lag in preparing the reports was a result of both the changeover of personnel, which has been corrected, and the late receipt of information needed from parties outside of the Museum, specifically from the University of Hawaii at Hilo. We have since instituted procedures and formal deadlines to ensure the necessary information is received on a timely basis. Since then, Federal Cash Transaction Reports have been filed on a timely basis.
- **Procurement Policy** - The Museum has subsequently updated its procurement, bids and quotations policy. The updated policy increases the threshold requiring competitive

bidding from \$2,500 to \$5,000. In addition, we have discussed with key staff the necessity of maintaining appropriate and complete documentation to adequately support its purchases.

- **Bids and Quotations Policy** - In addition to the above, the Museum has revised its bids and quotations policy to require the following procedures be followed for all federal grants:
 1. Avoid purchasing unnecessary items;
 2. Where appropriate, perform an analysis of lease and purchase alternatives to determine which would be the most economical and practical procurement for the Federal Government;
 3. Obtain solicitations for goods and services that include certain requirements; and
 4. Positive efforts shall be made to utilize small businesses, minority-owned firms, and women's business enterprises, whenever possible.

- **Documentation of Subrecipient Monitoring** - The Museum created a Subrecipient Monitoring policy effective March 2002. This includes requirements that subrecipient monitoring activities be documented in accordance with federal rules and regulations. We will ensure that the principal project managers that oversee subrecipient activities request, obtain, and maintain the minimum documentation required by the Federal Government.