

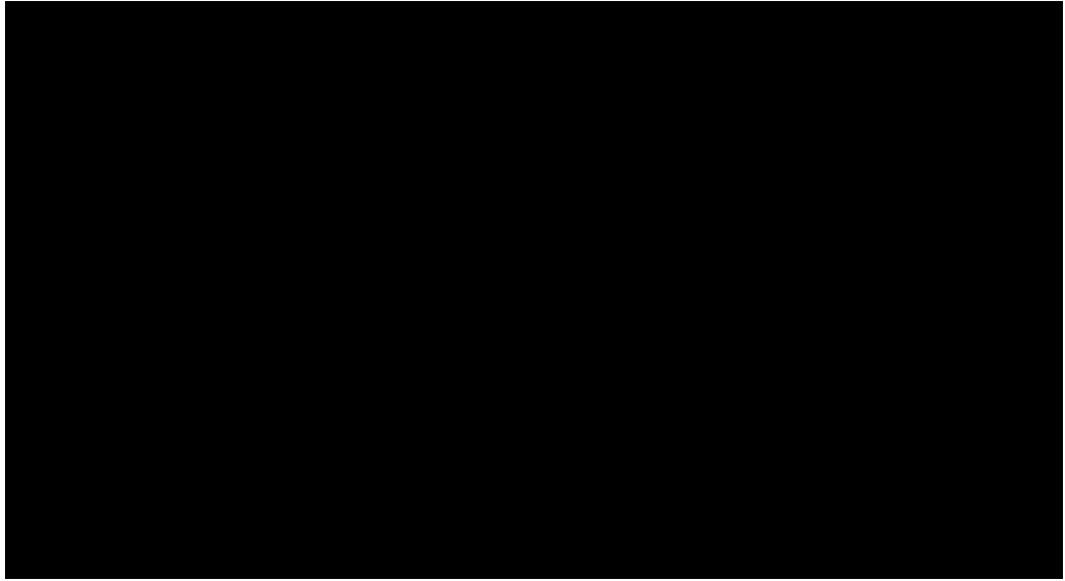
**Audit of United States-Mexico
Foundation for Science**

Mexico City, Mexico

**National Science Foundation
Office of Inspector General**

**December 8, 2004
OIG 05-2-005**





EXECUTIVE SUMMARY

This report provides the results of the Office of Inspector General's (OIG) audit of United States (U.S.) Government grants awarded to finance an endowment fund for the United States-Mexico Foundation for Science (USMFS). The original purpose of the audit was to evaluate (1) the adequacy of NSF policies and procedures for managing and monitoring the USMFS award and (2) whether the USMFS was administering NSF grant funds in accordance with award terms and conditions. However, because it was not practical to limit our review only to NSF's contribution for the USMFS endowment fund, our audit also included the contributions provided by the Environmental Protection Agency (EPA), the National Aeronautics and Space Administration (NASA), and the Department of Agriculture (USDA).

The USMFS was established in 1992 as a non-profit organization to promote cooperation in science and technology for the solution of problems of interest to both the United States and Mexico. The USMFS is located in Mexico City and organizes workshops, conferences, studies, and exchanges of scientists and engineers in order to define the scope and content of science projects and activities to address problems shared by both countries that are amenable to scientific and technological solutions. Since 1998, the U.S. and the Mexican Governments have contributed \$10.9 million and \$5.9 million, respectively, to the USMFS endowment fund. Total endowment investment earnings totaled approximately \$1.2 million during 2002, of which 54 percent was derived from the U.S. contributions and the remaining 46 percent from the Mexican contributions. The endowment investment earnings were to provide the USMFS with an established source of annual funds for its scientific projects as well as to support part of its operational costs.

We found that NSF and the three other federal agencies did not establish adequate grant agreements requiring the USMFS to comply with the three mandatory requirements established by the U.S. Appropriations law for funding the USMFS endowment. Public Law 106-74 appropriated monies for the USMFS endowment on the conditions that Mexico matches the U.S. funding, the USMFS implements the U.S. federal grant requirements, and the USMFS changes its name. Yet, each of the federal agencies failed to include one or more of these statutory requirements in their grant agreements. As such, the USMFS was not legally required and did not obtain \$5 million, or 45 percent, of matching endowment contributions from Mexico and did not implement the two remaining legislative provisions.

Because the USMFS was not in full compliance with the Act's requirements, NSF and the other three Federal agencies expended \$10.9 million in appropriated funds for the USMFS endowment contrary to Congress' express intent regarding how it wanted the funds to be used. Furthermore, due to the shortfall in Mexican matching contributions, the USMFS had limited funding for accomplishing its program goals. Specifically, assuming the \$5 million Mexican shortage would have earned the same interest rate as its other endowment investments, we estimated that the USMFS would have earned an additional \$362,000, or 29 percent, of its total 2003 investment earnings to support other endowment-sponsored projects.

Also, because the USMFS did not implement the legislatively mandated U.S. grant requirements, it lacked adequate internal controls to ensure that the U.S. share of the endowment principal and investment earnings was properly accounted for and administered. Specifically, the USMFS did not establish (1) a project cost-accounting system to track the expenditure of endowment earnings by each contributing federal agency and (2) basic internal controls for salary and travel expenditures. Moreover, since the USMFS did not implement the U.S. grant requirements, NSF and the other federal agencies received little value from the annual OMB Circular A-133 audit required by all four federal agency grant agreements.¹

Equally important, the USMFS did not establish adequate internal controls to ensure its endowment fund was properly managed. In particular, a proposed reserve account, set-aside to protect the value of the endowment fund from inflation, was under-funded by \$605,345, or 38 percent, between 1998 and 2003. Also, the USMFS inappropriately invested \$2.7 million, or 25 percent, of total U.S. endowment contributions in corporate bonds and equities instead of U.S. government-backed securities as required. Further, the USMFS did not establish dissolution procedures for the U.S. endowment principal of \$10.9 million and the U.S. share of reserve funds of almost \$720,000 to ensure the funds would be appropriately handled in accordance with U.S. grant provisions if the organization were to cease operations.

The primary factor contributing to the lack of adequate and consistent U.S. federal grant provisions implementing the three statutory requirements for funding the USMFS endowment occurred because of miscommunication between various agency offices. In NSF's case, these legislative requirements were not communicated to the agency's grants and program officials when Public Law 106-74 was enacted to ensure that the NSF grant agreement was appropriately amended. In addition, the four federal agencies did not coordinate with each other to develop consistent terms and conditions for their Congressionally-mandated funding of the USMFS endowment. Further, as a new and foreign awardee, the USMFS was not familiar with and did not fully understand its responsibilities for establishing a system of internal controls for managing its endowment contributions in compliance with its U.S. grant provisions.

We recommended that as the largest U.S. contributor, the NSF bring the statutory non-compliance issue to the attention of the President's Office of Science and Technology Policy (OSTP). NSF should formally propose that OSTP, in conjunction with the Department of State, coordinate efforts between NSF, NASA, EPA, and USDA regarding the corrective actions required to bring the Executive Branch in compliance with the three mandatory requirements established by Public Law 106-74. Also, in conjunction with these efforts, we recommended that NSF coordinate with the other federal agencies to establish consistent and clear U.S. federal grant provisions to ensure the USMFS institutes adequate internal controls for accounting and managing the endowment principal and reserve funds.

¹ The USMFS has only performed the required annual OMB Circular A-133 grant audit in 1999, the first year after the endowment fund was established.

A draft audit report, requesting comments, was issued to the cognizant NSF program and grants offices and to the USMFS. In general, NSF finds the audit report to be useful, but does not agree that the Foundation should take a leading role in coordinating corrective actions for the entire U.S. Government. Furthermore, NSF notes that the audit report has already been provided to OSTP, rendering formal notification by NSF as unnecessary. Nevertheless, NSF does generally agree to implement the remaining audit recommendations for its own contributions to the USMFS endowment fund. Specifically, NSF will take prompt actions to negotiate necessary changes to its grant agreement with the USMFS to comply with the mandatory legislative requirements of P.L. 106-74 and to establish clear requirements for USMFS management of the endowment principal and reserve funds.

The USMFS states that the facts presented in the audit report are generally accurate and that management has an appreciation for the concerns and recommendations raised. Accordingly, the USMFS agrees to work with the NSF and the other federal agencies to develop and implement corrective actions resulting from the audit recommendations. Additionally, it has begun the process of developing and implementing appropriate internal controls and procedures over its endowment fund.

After our review of the NSF and USMFS comments, we re-affirm our audit recommendations that NSF should coordinate its corrective actions with OSTP, the Department of State, and the other three federal agencies. Essentially, we believe that NSF has an inherent responsibility, on behalf of the Federal Government, to bring these matters to the attention of the OSTP, who can coordinate corrective actions between the federal agencies to ensure appropriated funds for the USMFS have been expended consistent with Congressional requirements. Furthermore, since the USMFS' accounting system, along with its administrative policies and procedures, are used to track expenditures and administer endowment funds for all contributing federal agencies, we continue to believe that it is essential for NSF to coordinate its efforts with the other agencies regarding needed accounting and internal control improvements.

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ACRONYMS

BOG	USMFS' Board of Governors
CONACyT	Mexico's National Council for Science and Technology
DIAS	NSF Division of Institution and Award Support
DGA	NSF Division of Grants and Agreement
EPA	U.S. Environmental Protection Agency
NASA	U.S. National Aeronautics and Space Administration
NSF	U.S. National Science Foundation
OISE	NSF's Office on International Science and Engineering
OLPA	NSF Office of Legislative and Public Affairs
OMB	U.S. Office of Management and Budget
OSTP	President's Office of Science and Technology Policy
USDA	U.S. Department of Agriculture
USMFS	United States-Mexico Foundation for Science

INTRODUCTION

BACKGROUND

The United States-Mexico Foundation for Science (USMFS), located in Mexico City, was established in 1992 as a non-profit organization to promote cooperation in science and technology for the solution of problems of interest to both the United States (U.S.) and Mexico. The USMFS organizes workshops, conferences, studies, and exchanges of scientists and engineers in order to define the scope and content of science projects and activities to address problems shared by both countries that are amenable to scientific and technological solutions. In 1998, the U.S. and Mexico agreed to establish an endowment fund and use the interest earned to partially fund the USMFS operations, whereas, previously the United States provided funding directly for the organization's operations.

The late George E. Brown, a member of the U.S. House of Representatives, played a key role in promoting science and technology collaboration between the U.S. and Mexico and was instrumental in the establishment of the USMFS as a vehicle for promoting that collaboration. Similarly, on the Mexican side, Carlos Bazdresch, the former General Director of the National Council for Science and Technology (CONACyT), the Mexican Government's counterpart agency to NSF, played a key role in the orientation and development of the USMFS.

A Board of Governors (BOG) consisting of sixteen members, eight from the U.S. and eight from Mexico, govern the USMFS. The BOG members include representatives from various Mexican government entities and private businesses and academic institutions in both the U.S. and Mexico. The BOG meets twice a year and its various responsibilities and authorities include: sanctioning and supervising the implementation of the USMFS work program, approving the organization's internal structure, approving systems of control and audit, and sanctioning endowment investment decisions.

An Executive Committee (EC) assists the BOG in accomplishing its responsibilities. The EC consists of four members of the BOG, two from each country, and also meets twice per year. The day-to-day management of the USMFS is the responsibility of its Executive Director, who is appointed by the BOG. The Executive Director proposes the operational structure of the organization to the BOG and is responsible for the execution of USMFS programs and projects. Among the Executive Director's many duties is responsibility for the financial management of the organization's resources. In 2003, a staff of 33 employees supported the Executive Director.

The USMFS total income was approximately \$2.9 million in 2002. This included approximately \$1.7 million in external funds from governments, private foundations, and university organizations in the U.S. and Mexico and internal funds of approximately \$1.2 million of interest earned on the endowment fund. The income derived from the endowment was used to define and start the development of the USMFS' science and technology programmatic activities as well as to cover a portion of the organization's annual operating expenses. In other words, the income derived from the USMFS

endowment fund serves as seed money and as a catalyst for the bi-national science and technology programs that then seek funding from major public and private donors.

U.S. and Mexico Contributions to the USMFS Endowment Fund

Since 1998, the U.S. Government has contributed \$10.9 million and the Mexican Government \$5.9 million to the USMFS endowment fund. Of the U.S. portion, NSF contributed \$4 million, or 37 percent, with the remaining funds provided by the Environmental Protection Agency (EPA), the National Aeronautics and Space Administration (NASA), and the U.S. Department of Agriculture (USDA). No further U.S. or Mexican contributions to the USMFS endowment are planned. Endowment investment earnings totaled approximately \$1.2 million during 2002, of which the NSF portion was about \$245,000. A breakdown of endowment contributions and 2002 interest earned by each agency contributing to the USMFS endowment fund follows:

Agency	Total Endowment Contributions	Percentage of Total Endowment Contributions	FY 2002 Endowment Interest Earned	Percentage of Total Endowment Interest Earned
NSF	\$4,000,000	23.7%	\$244,912	19.8%
EPA	\$2,000,000	11.9%	\$127,887	10.3%
NASA	\$3,000,000	17.8%	\$178,734	14.4%
USDA	\$1,900,000	11.3%	\$113,866	9.2%
U.S. Subtotal	\$10,900,000	64.7%	\$665,399	53.8%
CONACyT	\$5,947,368	35.3%	\$571,644	46.2%
Total	\$16,847,368	100.0%	\$1,237,043	100.0%

Each of the four federal agencies issued separate grant agreements to provide their contributions to the USMFS endowment fund. Currently, only the NSF award remains active. Because of the unique nature of the funding for the USMFS endowment, NSF did not use its typical grant or cooperative agreement to provide the Congressionally-mandated \$4 million contribution. Instead a special “Funding Arrangement” was developed for providing NSF’s Congressionally-mandated contributions under NSF award INT-9815601, effective August 1, 1998 and expiring on September 30, 2091.² Under the terms of the “Funding Arrangement,” CONACyT, on behalf of Mexico, was required to match the U.S. contributions. Additionally, the U.S. contributions were to be invested in U.S. government-backed securities, guaranteeing the preservation of principal, and a reserve amount was to be established to protect the endowment principal from inflation.

² The period of performance for NSF award No. INT-9815602 was established based on the life of the endowment, which is consistent with the 99-year life of the USMFS as stated in its founding document.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were to evaluate (1) the adequacy of NSF policies and procedures for managing and monitoring awards to the USMFS to ensure compliance with applicable U.S. laws and federal regulations and (2) whether the USMFS was administering NSF award funds in accordance with the grant terms and conditions. Because it was not practical to limit our review to only NSF's contribution for the endowment fund, this report addresses the USMFS' overall administration of the total \$10.9 million of U.S. government contributions from 1998 through December 15, 2003. However, our review of the USMFS expenditure of endowment interest was limited to costs incurred in 2002. Of these amounts, specific emphasis was given to the administration of NSF's contribution to the endowment fund awarded under NSF award no. INT-9815601.

During the audit, we reviewed U.S. government legislation applicable to the USMFS endowment fund; federal and NSF grant policy and procedures; applicable NSF, NASA, EPA, and USDA grant agreements; and the NSF award jacket. We interviewed cognizant program and grants officials at NSF and the other three U.S. federal agencies to gain an understanding of the steps taken to award and monitor the grants used to fund the USMFS endowment fund.

In evaluating the adequacy of the USMFS' administration of U.S. contributions to the endowment fund and the interest earnings, we reviewed the organization's internal financial and management controls to safeguard U.S. government funds. We reviewed the USMFS expenditures reflected in its financial reports and tested a limited sample of expenditures incurred from January to December 2002. Although our onsite review at the USMFS was performed in December 2003, the organization did not have complete accounting records for 2003, due to a conversion to a new accounting system, which required us to limit our primary testing to 2002 financial transactions. However, the review of financial transactions was extended to other periods as deemed necessary. We toured the USMFS offices and interviewed key personnel to gain an understanding of management controls in place. Additionally, we interviewed the USMFS' current financial statement auditors, an official from the USMFS' prior accounting services firm, and the prior auditors, which conducted the 1999 audit under guidelines contained in OMB Circular A-133, "*Audits of Institutions of Higher Education and Other Nonprofit Organizations.*"

We conducted our audit in accordance with the U.S. Comptroller General's *Government Audit Standards* and included such test of accounting records and other auditing procedures, as we considered necessary, to fully address the audit objectives.

FINDINGS AND RECOMMENDATIONS

1. NSF and Other Federal Agencies Need to Develop Grant Provisions to Ensure Compliance with U.S. Appropriations Statute

Public Law 106-74 (the Act) appropriated monies for the USMFS endowment fund on the conditions that Mexico matches the U.S. funding, the USMFS implements the U.S. federal grant requirements,³ and the USMFS changes its name to commemorate Representative George E. Brown. However, NSF and the three other federal agencies, that funded the USMFS endowment, did not include one or more of these three statutory requirements in their grant agreements. In addition, the USMFS did not comply with the mandatory provisions that were included in the federal grant agreements. Consequently, the USMFS did not obtain \$5 million, or 45 percent, of matching endowment funds from Mexico, did not implement the federal grant requirements, and did not change its name. Because the USMFS is not in full compliance with the Act's requirements, NSF and the other Federal agencies have expended their appropriated funds contrary to the intent of Congress. Also, the shortfall in Mexican matching funds has limited the USMFS' efforts to accomplish its program goals. Furthermore, the USMFS lacks adequate internal controls over the U.S. endowment funds because it has not implemented the U.S. grant requirements. This occurred because of miscommunication between NSF offices in not notifying the responsible grants and program staff of the three statutory conditions for funding the USMFS endowment when P.L. 106-74⁴ was enacted. Similarly, the other federal agencies were also not aware of the mandatory conditions contained in the Act.

Mandatory Legislative Requirements Established For Funding of the USMFS Endowment

On October 20, 1999, Congress enacted Public Law 106-74, *The Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 2000* to appropriate fiscal year 2000 monies to fund the USMFS endowment. While Section 423 of the Act established clear legislative authority for federal agencies to fund the USMFS endowment, it also established three mandatory conditions for the funding. The three conditions constituted a constraint on the use of the appropriated funds and reflected Congress' express intent regarding how it wanted the funds to be used. Section 423 of the Act states:

³ Federal grant requirements include the U.S. grant administrative requirements as prescribed by OMB Circular A-110, "Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Non-Profit Organizations," the federal cost principles as prescribed by OMB Circular A-122, "Cost Principles for Non-Profit Organizations," and the grant audit requirement as prescribed by OMB Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Organizations."

⁴ The prior year, PL 105-276, appropriated U.S. monies for the USMFS endowment fund for fiscal year 1999, but did not require that USMFS meet these same conditions.

SEC. 423. Notwithstanding any other law, funds made available by this or another Act or previous Acts for the United States/Mexico Foundation for Science may be used for the endowment of such Foundation: *Provided*, That funds from the United States Government shall be matched in equal amounts with funds from Mexico: *Provided further*, That the accounts of such Foundation shall be subject to United States Government administrative and audit requirements concerning grants and requirements concerning cost principles for nonprofit organizations: *Provided further*, That the United States/Mexico Foundation for Science is renamed the ‘George E. Brown United States/Mexico Foundation for Science.’

By its own terms, Section 423 applies to any endowment “funds made available by this or any other Act or previous Acts for the United States/Mexico Foundation for Science,” thus these three mandatory conditions are applicable to all U.S. funds appropriated for the USMFS endowment. This includes any prior funding and those provided by any other federal agency; therefore, the provisions were applicable to all endowment contributions made by NSF, NASA, EPA, and USDA.

U.S. Grant Agreements Lacked Provisions to Implement Legislative Requirements

Yet, NSF and the other three federal agencies did not incorporate the three Section 423 statutory requirements into their grant agreements for funding the USMFS endowment. Three of the four agency agreements required the USMFS to obtain matching funds from Mexico, two required the USMFS to comply with the U.S. grant requirements, but none of the agreements required the USMFS to change its name.

Specifically, the NSF grant agreement required the USMFS to obtain matching funds, but did not require it to fully comply with the U.S. grant requirements or to change its name. Because of the unique nature of USMFS endowment funding, NSF developed a special “Funding Arrangement” to provide NSF’s Congressionally-mandated contributions. Accordingly, on August 1, 1998, NSF issued award INT-9815601, effective through September 2091. Provision VII of the “Funding Arrangement” required CONACyT, the Mexican counterpart agency to NSF, to “match on a one for one basis any contributions made by NSF or other U. S. government agencies.” The provision also specified that NSF or **the other federal agencies** could reclaim their contributions if Mexico did not match the U.S. funding within 180 days. NSF officials stated that the NSF grant provisions included the endowment contributions made by the other Federal agencies because at the time the award was made, only the NSF had clear legislative authority, pursuant to its organic act, to fund an endowment. Thus, these NSF grant provisions provided the option for other agencies to fund the endowment through NSF if necessary.

Further, the NSF agreement required the USMFS to arrange for annual audits pursuant to OMB Circular A-133, “*Audits of Institutions of Higher Education and Other Nonprofit Organizations.*” However, it did not require the USMFS to comply with the U.S. grant administrative requirements and cost principles for non-profit organizations, or to change its name. Without requiring the USMFS to adhere to these U.S. grant requirements, the usefulness of the annual A-133 audit required would be of limited value to NSF.

Similarly, the NASA, EPA, and USDA grant agreements were also lacking in implementing all of the Act’s requirements. While the EPA and USDA grant agreements required Mexico to match the U.S. funding, NASA’s grant agreement did not include such a provision. Additionally, like the NSF agreement, only the EPA grant agreement allowed the agency to reclaim its contribution if Mexico did not pay its matching share. But both the NASA and EPA grant agreements did require the USMFS to comply with the U.S. grant administrative requirements, cost principles, and audit requirements as mandated by the Act. But none of the grant agreements required the USMFS to change its name. Details of our analysis follow:

Federal Agency Grant Provisions for USMFS Endowment Fund

<u>Agency</u>	<u>Matching Requirement In Grant Agreement</u>	<u>Reclaim U.S. Contribution If Lack of Mexico Match</u>	<u>U.S. Grant Administrative Requirements</u>	<u>Federal Grant Cost Principles</u>	<u>A-133 Audit Requirement</u>	<u>Name Change Requirement</u>
NSF	Yes	Yes	No	No	Yes	No
NASA	No	No	Yes	Yes	Yes	No
EPA	Yes	Yes	Yes	Yes	Yes	No
USDA	Yes	No	No	No	Yes	No

The NSF and the other three federal agencies did not include all of the Act’s statutory requirements in its grant agreements because of miscommunication between agency officials. Although NSF’s Office of Legislative and Public Affairs (OLPA) was responsible for assuring that NSF’s grants and program staff were aware of the statutory requirements for funding the USMFS endowment, OLPA could not find any documentation that it had notified cognizant officials of the Section 423 requirements. Therefore, NSF grants officials did not appropriately amend the grant agreement to include the new statutory provisions of P.L. 106-74 that were enacted more than one year after the initial award to the USMFS. Similarly, discussions with NASA, EPA, and USDA grants and program officials disclosed that the other agencies were also not aware of the Section 423 legislative requirements.

USMFS Did Not Comply With Provisions of U.S. Grant Agreements

Equally important, the USMFS did not comply with all of the provisions that were included in the four federal agency grant agreements. Specifically, it did not obtain matching funds from Mexico for \$4,952,632, or 45 percent, of the total U.S. endowment contributions. Of the total U.S. contributions of \$10.9 million, CONACyT, on behalf of the Mexican Government, has essentially matched NSF’s contribution of \$4 million and \$2 million of NASA’s contribution. However, it has not matched the remaining \$1 million of NASA funding, \$2 million of EPA funding, and \$1.9 million of USDA

funding. In general, CONACyT matched the U.S. contributions in chronological order of each federal agency's payment, thus it was the later U.S. contributions that were not matched. A detailed analysis of the U.S. and Mexican contributions to the USMSF endowment follow:

U. S. Agency	Matching Requirement In Grant Agreement	U. S. Contribution Paid	Contribution Matched by Mexico	Contribution Not Matched By Mexico (Shortage)	Total U.S. and Mexico Contributions
NSF	Yes	\$4,000,000	\$3,947,368	\$ 52,632	\$7,947,368
NASA	No	\$3,000,000	\$2,000,000	\$1,000,000	\$5,000,000
EPA	Yes	\$2,000,000	0	\$2,000,000	\$2,000,000
USDA	Yes	\$1,900,000	0	\$1,900,000	\$1,900,000
Total		\$10,900,000	\$5,947,368	\$4,952,632	\$16,847,368

The U.S. federal agencies did not pursue the Mexico matching funds for several reasons. In NSF's case, it was satisfied that CONACyT had matched NSF's endowment contributions and did not believe that it was responsible for seeking Mexico's matching share for the other federal agencies. Officials from the other federal agencies stated that they did not take actions to ensure that the USMFS obtained the matching Mexican funds because they were uncertain how and/whether they were required to enforce such a requirement given that Congress had mandated their agencies to contribute the specific amounts to the endowment fund. Discussions with the USMFS Executive Director disclosed that efforts to obtain the required matching share from CONACyT, on behalf of the Mexican Government, had not been successful because of the poor economic conditions in Mexico over recent years.

Additionally, our onsite review disclosed that the USMFS had not implemented the U.S. grant administrative requirements or cost principles as required by the NASA and EPA grant agreements. As a foreign awardee, the USMFS officials were totally unaware of the U.S. administrative requirements and cost principles and the existence of the applicable OMB Circulars, which detail these grant requirements. However, as required by all the agencies' grant agreements, the USMFS did have an OMB Circular A-133 audit completed in 1999, but has not had the audit performed since that time. According to the USMFS Executive Director, the A-133 audits were not performed because of the additional costs required to perform such reviews in addition to their annual financial statement audits.

Appropriation of USMFS Endowment Funds Do Not Meet Statutory Requirements

As a result of the USMFS' lack of full compliance with the Act's legislative requirements, the four federal agencies have expended their appropriated funds contrary to the intent of Congress. Additionally, the USMFS has been limited in accomplishing its program goals due to the shortfall in matching Mexican funds and lacked adequate

internal controls over the expenditure of U.S. endowment interest earnings. Specifically, the three conditions required by Section 423 of P.L. 106-74 constituted a clear constraint by Congress on how it wanted the appropriated funds for the USMFS endowment to be provided and administered. By awarding the funds without grant provisions requiring the USMFS to satisfy the three statutory requirements, the four federal agencies have not properly administered the appropriated funds provided by Congress

Furthermore, the Act required Mexico to match the U.S. contributions to provide the USMFS with an established source of funding for its operations and scientific programs. As such, the \$4,952,632 shortage of Mexican matching contributions has reduced the USMFS' total annual financial resources. Assuming the \$4,952,632 would have earned the same interest rate as Mexico's other endowment contributions, it is estimated that the USMFS would have earned an additional \$361,542, or 29 percent, of total interest earned in 2003 to support its operations and scientific programs. The lack of such additional funds limited the USMFS' accomplishment of its program goals.

Further, we believe the language in the Act imposing U.S. grant requirements on the accounts of USMFS was intended to ensure accountability over the U.S. endowment contributions. However, because the USMFS did not implement these requirements, we found that it did not establish adequate internal controls to ensure that the U.S. share of the endowment principal and earned interest was properly accounted for and administered. Specifically, contrary to federal grant requirements, the USMFS lacked a project cost-accounting system to track the expenditure of endowment interest earnings by each contributing federal agency and the USMFS claimed some grant costs that were unsupported or unallowable pursuant to the federal cost principles. Also, it was not administering the endowment fund in compliance with all provisions of its NSF and other federal agency grant agreements. Further details of these issues are discussed in Finding 2 and 3 of the audit report.

Lastly, Congress intended to commemorate Representative George Brown by requiring the USMFS to change its name. Representative Brown was instrumental in helping both to establish the USMFS in 1992 and its endowment fund in 1998. Yet, because NSF and the other federal agencies did not inform the USMFS of this statutory requirement, this name change was not made.

Conclusion

Because Section 423 of the Act affects all four of the U.S. contributing agencies, NSF cannot unilaterally take corrective action that will remedy the statutory non-compliance with the three mandatory conditions established for funding the USMFS endowment. Nevertheless, as the largest U.S. contributor, NSF needs to take the lead to bring this matter to the attention of the President's Office of Science and Technology Policy (OSTP) and propose that it coordinate efforts between NSF, NASA, EPA, and USDA to develop a strategy to bring the four agencies in compliance with the Act.

Such a U.S. government strategy can include directing the USMFS to issue a formal written request to CONACyT asking for payment of the \$5 million Mexican government shortage, clearly specifying that U.S. law requires the matching funds. Further, it could be suggested that an installment repayment plan be established to recover the Mexican shortage. Alternatively, the U.S. Government could seek the return of its endowment contributions or OSTP and the agencies could propose that Congress change the law. Because this matter involves the relationship between the governments of the U.S. and Mexico, we also believe that the U.S. State Department should also be consulted on the appropriate corrective course of action needed.

Recommendations

We recommend that the Director, Office of International Science and Engineering (OISE), in consultation with the General Counsel and the Director, Office of Legislative and Public Affairs (OLPA):

- 1.1 Formally notify OSTP of the NSF and the Executive Branch's statutory non-compliance with the three mandatory requirements established in Section 423 of P. L. 106-74 for funding the USMSF endowment and propose that OSTP, in conjunction with the Department of State, coordinate efforts between NSF, NASA, EPA, and USDA on the corrective actions required to bring the Executive Branch in compliance with the intent of Congress as expressed in Section 423.

We recommend that the Director, Division of Grants and Agreements (DGA) and the Director, Division of Institution and Award Support (DIAS), in consultation with the Director, OISE:

- 1.2 Amend the NSF "Funding Arrangement" with the USMFS to ensure that endowment contributions are managed in full compliance with Section 423 of P. L. 106-74 requirements based on the required corrective actions identified from recommendation 1.1 above.

NSF Comments

NSF states that the audit report is useful, but does not agree that it should take a leading role to coordinate efforts with the other three federal agencies to enforce the provisions of Section 423 of P.L. 106-74. Specifically, NSF states that it lacks the authority to take such a leading role because there is no legal relationship between NSF and the three other federal agencies with regard to the USMFS. Therefore, NSF rejects recommendation 1.1 to bring the statutory non-compliance issue to OSTP's attention and propose that it coordinate corrective actions needed between the four agencies. Additionally, NSF states that a formal notification is not necessary because the OIG has already provided OSTP a copy of the audit report.

However, NSF partially agrees with recommendation 1.2 and will negotiate with the USMFS to amend its award agreement to implement the Section 423 statutory

requirements with respect to NSF's funding of the USMFS endowment fund. Specifically, NSF will include "the administrative and audit requirements specified in P.L. 106-74" and provide for renaming of the organization. NSF notes, however, that the renaming of the USMFS may require negotiation with the Mexican Government and exceeds NSF's authority. Furthermore, NSF plans to delete all current grant provisions referencing endowment contributions made by the other federal agencies.

USMFS Comments

While the USMFS states that the facts presented in the audit report are accurate, it does not state its position on the preceding audit conclusions and recommendations. Nevertheless, the USMFS agrees to work with NSF and the other federal agencies to develop and implement corrective actions resulting from the audit recommendations.

OIG Response

While there is merit with NSF's position that it does not have the authority to require the other federal agencies to comply with the three mandatory Section 423 requirements of P.L. 106-74, we believe that NSF has the responsibility to bring this matter to the attention of the OSTP, who does have such authority. OSTP can coordinate efforts between the four federal agencies to remedy the fact that U.S. appropriated funds have been expended contrary to the expressed intent of how Congress wanted the funds for the USMFS to be used. Additionally, because NSF's grant agreement specifically requires Mexico to match endowment contributions made by the other federal agencies, NSF should not delete this grant provision without coordinating its efforts with OSTP and the other agencies. This NSF grant provision could be essential in the Executive Branch's efforts to initiate appropriate corrective actions to achieve compliance with the matching requirement mandated by Section 423; therefore, we reaffirm audit recommendation 1.1.

With regard to Recommendation 1.2, NSF's proposed corrective actions to amend its grant agreement with the USMFS to include the Section 423 statutory requirements are appropriate. However, to fully implement the legislative requirements, NSF must also include the "cost principles for nonprofit organizations" as prescribed by Section 423. In this regard, we believe that NSF should specifically require USMFS compliance with the applicable OMB Circulars, which establish U.S. grant administrative requirements, cost principles, and audit requirements.⁵ These OMB standards will establish clear requirements for sound financial management systems to account for grant funds and ensure the federal funds are spent on reasonable and allowable grant activities.

Additionally, it is unclear whether NSF's proposed action to amend the grant provisions to require the USMFS to change its name will bring NSF in full compliance with the Section 423 requirement. As NSF notes, if negotiations with the Mexican Government are required to achieve the name change, then NSF would not have the authority to

⁵ OMB Circular A-110 establishes administrative requirements for grants, OMB Circular A-122 establishes cost principles for non-profit organizations, and OMB Circular A-133 establishes audit requirements for grants.

engage in such negotiations with a foreign government. Therefore, supporting our position, as reflected in recommendation 1.1, that the Department of State be consulted and involved in the corrective actions required to bring NSF and the other federal agencies in compliance with the Section 423 legislative requirements. We once again, reaffirm that NSF work together with OSTP, the Department of State, and the other federal agencies to maximize the success of its proposed corrective actions.

2. USMFS Needs To Improve Financial Management Processes and Obtain A-133 Audits

NSF and the other federal agency grant agreements were not adequate to implement all legislative requirements for funding the USMFS endowment. While two of the four grant agreements required the USMFS to comply with the U.S. grant administrative requirements and cost principles, the NSF grant agreement did not include these requirements. Additionally, although all the grant agreements included the legislatively required OMB Circular A-133 audit, such an audit is not meaningful without mandatory USMFS compliance with the U.S. grant administrative and cost principles, which establish the standards for such a review. As a result, because the U.S. grant administrative and cost principles were not implemented, we found that the USMFS lacked (i) a cost-accounting system to record and track project costs funded by each individual federal agency, (ii) basic internal controls over salary and travel expenditures, and (iii) useful OMB Circular A-133 audits. This occurred because as a new as well as a foreign awardee, the USMFS lacked a clear understanding of its federal grant responsibilities to establish adequate internal controls for managing and administering the expenditure of its endowment investment earnings.

USMFS Lacks Written Internal Control Policies and Procedures for its Cost-Accounting System

U.S. award recipients are responsible for establishing written policies and procedures that describe an effective system of internal controls⁶ to ensure that the U.S. grant funds are properly accounted for, administered, and monitored in a cost-accounting system by each federal award. Pursuant to the federal grant administrative requirements, prescribed by OMB Circular A-110,⁷ this type of accounting system should provide for:

- Accurate and complete disclosure of the financial results of each federal award and project;
- Identification through accounting records of the source and application of funds for each federal award and project;
- Effective control over and accountability for all funds, property, and other assets;
- Written procedures for determining the reasonableness, allocability and allowability of incurred costs; and,

⁶ Internal controls are policies and procedures to provide reasonable assurance that an organization is achieving its objectives for effective and efficient operations, reliable financial data, and compliance with applicable laws and regulations.

⁷ OMB Circular A-110 is entitled, “*Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Non-Profit Organizations.*”

- Accounting records that are supported by source documentation for each federal award and project.

Further, the NSF, EPA, and USDA grant agreements required the USMFS to provide an annual report to “include a fiscal report of contributions to the Endowment, interest earned on the Endowment and the expenditure of the interest earned . . .”

However, our review of this required USMFS’ annual financial endowment report, entitled Format A-133 FY 2002 (see copy at Appendix A on page 28), disclosed that the project expenses and/or operational costs reported for each federal agency were not supported by the accounting records. The USMFS was not able to provide documentation supporting the individual agency costs or any written policies or procedures specifying the methodology used to allocate the total endowment expenditures to each agency. The USMFS’ accounting system did not have the capability to segregate the expenditure of endowment interest earnings by each supporting agency as is required by OMB Circular A-110; and therefore, commingled all endowment expenditures. Accordingly, the reported expenditures for each federal agency were based on a subjective allocation of the total endowment expenditures rather than an accounting of the actual expenditures incurred for the projects. As a result, NSF and each of the three federal agencies were unable to determine how their endowment earnings were spent to verify that the disbursements were for authorized grant purposes.

Nevertheless, given the unusual nature of funding the USMFS endowment, the federal agencies need to determine the level of cost segregation required to provide for adequate accountability over the expenditure of their endowment interest earnings. A possible alternative could be only to require the USMFS to segregate costs by each project funded by the endowment interest, regardless of the source of the funds. Such total cost segregation by each endowment-sponsored project would be appropriate under special grant conditions clearly identified in the award agreements. These conditions could clearly delineate that unallowable federal grant costs be tracked in separate accounts to clearly show that U.S. funds were not used for such expenditures. Thus, precluding the requirement that actual project costs incurred for each project by funding source be separately tracked in the accounting records.

Better Internal Controls Needed for USMFS Salary and Travel Costs

Additionally, the USMFS lacked written policies and procedures governing expenditures for salaries and travel as would be required by federal grant requirements. The USMFS did not have an employee timekeeping system supporting its annual payroll costs. The USMFS employees were basically on an honor system and were not required to maintain time and attendance records. Additionally, the USMFS allocated staff costs to specific projects funded by the endowment interest earnings based on budgeted costs rather than employee time and effort records, as is typically required by the federal cost principles under OMB Circular A-122. The lack of supporting accounting documentation for payroll costs is a significant internal control deficiency given that the USMFS had 33 employees and total annual salary costs of approximately \$700,000. Without such labor

effort records, the USMFS cannot ensure that the salary costs claimed represented actual labor hours worked.

Additionally, USMFS did not have an established system for approving and reimbursing travel expenditures. There was no standard travel authorization form or travel voucher reimbursement form clearly specifying the name of the traveler, the purpose of the travel, and the authorized amount to be paid to the traveler. The lack of written travel procedures resulted in NSF and the other federal agencies having less assurance that the USMFS travel costs were properly authorized and actually benefited their endowment-sponsored projects. Also, the travel expenses paid were not always allowable if federal cost principles had been applied. For example, our review of supporting travel documentation commonly disclosed reimbursement for alcoholic beverages. Specifically, we noted that charges for BOG alcoholic beverages in fiscal year 2002 totaled over \$500. Additionally, first and business class airfares and upgrades of approximately \$3,000 in fiscal year 2002 were paid for BOG members and their spouses.⁸ While these unallowable costs were not a significant portion of the USMFS' travel expenditures, the USMFS accountant stated that travel claims were always paid as long as receipts were provided because the organization did not have established travel guidelines to question the reasonableness or allowability of any claimed travel costs.

Required OMB Circular A-133 and Other USMFS Audits Have Limited Usefulness

Although all four U.S. grant agreements required an OMB Circular A-133 audit, the usefulness of such an audit to the federal agencies for evaluating accountability over endowment funds was limited because two of the agreements, including NSF's, did not require compliance with the U.S. grant administrative requirements and federal cost principles that establish the basis or standards for the audit. One of the major objectives of an A-133 audit is to test grantee compliance with the specific U.S. grant administrative requirements and cost principles prescribed by federal regulations. These requirements hold awardees responsible for having sound financial management systems to account for federal grant funds and to ensure that they are spent on reasonable and allowable grant activities. But since the NSF grant agreement did not require the USMFS to comply with these regulations, the audit would not be able to accomplish its primary objective of evaluating USMFS compliance with these standards.

Furthermore, the A-133 audit was only performed for one year and was of questionable quality. While the OMB Circular required annual audits, the USMFS had only obtained the audit for 1999, the first year following the endowment's establishment. Also, while the 1999 audit concluded that the Schedule of Expenditures of Federal Awards (similar to Appendix A on page 28) was fairly presented and the USMFS had established and maintained effective internal controls over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs; the validity of the auditor's conclusion is questionable. Specifically, the expenditure of endowment interest was not segregated in the accounting system to permit verification of the Schedule of Expenditures of Federal Awards by each contributing federal agency. Also, it is evident

⁸ Furthermore, the NSF and USDA grant agreements specifically limited airfares to economy class.

that since the USMFS staff were not aware of or familiar with the U.S. grant administrative requirements and cost principles as specified in applicable OMB Circulars, the organization could not have been in compliance with these federal regulations as concluded in the A-133 audit report. Discussions with the cognizant international accounting firm officials confirmed that there was a lack of experience in performing OMB Circular A-133 audits.

Finally, the USMFS did have financial statement audits performed annually that included a review of the endowment interest receipts and expenditures. The auditors issued unqualified opinions and concluded that the financial statements reasonably presented the financial position of the USMFS in accordance with generally accepted auditing principles in Mexico. Yet, based on U.S. audit standards, the lack of written procedures and adequate supporting documentation for basic USMFS expenditures such as salary costs would have at a minimum required disclosure as an internal control weakness.

USMFS Staff Lacked Understanding of Financial Management Controls

The USMFS did not establish effective internal controls for managing and accounting for its endowment expenditures to ensure compliance with its federal grant agreements because as a new as well as a foreign organization, it lacked a clear understanding of the need to establish written policies and procedures for its basic operational processes. The USMFS did not have staff with adequate financial management expertise that recognized the importance of establishing a system of internal controls for managing the organization's financial and grant administration operations. Specifically, the USMFS contracted out for basic accounting services and did not hire an in-house accountant until 2002. Discussions with the USMFS former accounting services firm disclosed that they were tasked to provide bookkeeping services only and not to provide advice on internal control procedures. As a result, internal accounting and administrative controls were not designed and established to provide reasonable assurance that the USMFS had effective operations to accomplish its mission and to safeguard assets and provide for reliable financial data.

Concomitantly, as a foreign organization, the USMFS did not understand NSF and federal grant requirements or its responsibilities to ensure full adherence with all award conditions and prudent management of all activities affecting its endowment fund. USMFS officials were not aware of the U.S. grant administrative requirements or the cost principles, thus they were not aware that a project cost-accounting system was required to properly account for, administer and monitor costs by individual federal grants or projects. Furthermore, while NSF's "Funding Arrangement" required an OMB Circular A-133 audit, the USMFS Director stated that they have not performed the annual audits since 1999 because of the required additional costs and because neither NSF or the other federal agencies had ever requested the A-133 audit reports over the years.

Contributing to the problem, we believe that the audit firms engaged by the USMFS to perform its annual financial statement audits and its OMB Circular A-133 audit in 1999 were both remiss in their responsibilities not to advise the USMFS of the need to improve

its system of internal control when there were clearly no written operating policies and procedures for its basic operations. As a result, the USMFS was never informed of any needed improvements in its operations or changes required in the presentation of its financial data. In addition, the current USMFS financial statement auditors do not possess the expertise or experience to perform the required annual A-133 audits.

It is imperative that NSF and the other federal agencies coordinate efforts to establish consistent federal grant provisions for financial accountability over USMFS expenditure of U.S. endowment earnings. The four agencies must ensure that the USMFS is clearly required by their grant agreements to comply with the U.S. federal administrative requirements, cost principles, and audit requirements as specified by P.L. 106-74 and previously discussed in Finding 1. If the agencies agree that modification of such requirements are justified because of the atypical nature of funding the endowment, special grant conditions must clearly delineate such changes. Also, technical assistance should be provided to the USMFS to ensure a clear understanding of such decisions that will directly impact the requirements of its project cost-accounting system and annual A-133 audit.

Recommendations

We recommend that the Director, OISE in consultation with the Director, DGA and Director, DIAS:

2.1 Coordinate with NASA, EPA, and USDA officials to clarify the U.S. government requirements for the USMFS' project cost-accounting system for endowment expenditures.

We recommend that the Director, DGA and Director, DIAS in consultation with the Director, OISE:

2.2 Require the USMFS to improve its internal controls over the expenditure of endowment interest by establishing written policies and procedures for salary and travel expenditures. Specifically, airfares should be limited to economy class as required by the NSF grant agreement.

2.3 Based on consultation with other agencies as specified in Recommendation 2.1 above, provide clarification to the USMFS on how the required annual fiscal report of endowment expenditures (shown in Appendix) should be presented and require that such financial data be supported by its accounting records.

2.4 Direct the USMFS to arrange for OMB Circular A-133 audits annually in the future as required by the NSF grant agreement.

2.5 Provide technical assistance to the USMFS to ensure that:

- Cognizant staff clearly understands federal grant requirements, as prescribed by the applicable OMB Circulars, through appropriate training classes.
- Auditors with adequate expertise and experience are engaged to perform the required OMB Circular A-133 audits.

NSF Comments

NSF rejects recommendation 2.1, but accepts recommendations 2.2 through 2.5. Once again, NSF states that it does not have the authority to take the lead in coordinating efforts with the other three federal agencies to improve USMFS financial management procedures and OMB Circular A-133 audit processes. However, it agrees to implement the remaining audit recommendations as they pertain to NSF funding of the USMFS endowment. Specifically, NSF plans to negotiate changes to its grant agreement with the USMFS to introduce the administrative and audit requirements as specified in Section 423 of P.L. 106-74.

Specifically, with regard to recommendation 2.3, NSF states that the USMFS annual fiscal endowment report (see Appendix A on page 28) appears to include the required information on endowment contributions and interest earned and expended, as required by Section V of its grant agreement. Also, for recommendation 2.4, NSF specifies that Section C (5) of its grant “agreement did not require annual audits or that USMFS comply with OMB Circular A-133.”

USMFS Comments

While the USMFS states that the facts presented in the audit report are accurate, it does not state its position on the audit conclusions and recommendations. However, the USMFS states it has begun the process of developing and implementing appropriate internal controls and procedures based on the observations and comments of the draft report. Also, the USMFS agrees to work with NSF and the other federal agencies to improve its relevant internal procedures and controls resulting from the audit recommendations. As such, the USMFS has retained an accounting firm in Mexico, which is being advised by an international accounting company on the requirements of relevant U.S. regulations including OMB Circulars A-110, A-122, and A-133.

OIG Response

With regard to audit recommendation 2.1, since the USMFS project cost-accounting system is used to track endowment expenditures for all contributing agencies, we continue to believe that it is essential for NSF to coordinate its efforts with the other federal agencies regarding requirements for the USMFS to separately record and track project costs funded by each individual federal agency. Furthermore, at a minimum, NSF needs to clarify its own requirement regarding such accounting system requirements

for the NSF portion of endowment expenditures. Specifically, NSF's comment that the USMFS annual financial endowment report (Appendix A on page 28) appear to include the required information on expenditures of the interest, indicates that NSF does not understand that much of the financial data reflected in this annual report is not supported by the USMFS accounting records. In particular, the financial records document none of the project costs reported for NSF or the other contributing agencies because the USMFS accounting system commingles all expenditures of the interest. Pursuant to U.S. accounting standards, such a deficiency in an organization's financial reports would be considered a material internal control weakness. Thus, we reaffirm audit recommendation 2.1.

With regard to recommendations 2.2 through 2.5, NSF's proposed corrective actions to amend its grant agreement with the USMFS to include the administrative and audit requirements for grants are appropriate. However, to fully implement these recommendations, as previously noted in Finding A, NSF must also include the "cost principles for nonprofit organizations." Similarly, we reaffirm our position that the applicable OMB Circulars, which establish U.S. grant administrative requirements, cost principles, and audit requirements, should be used to institute such new NSF grant standards.

In addition, with regard to recommendation 2.4, NSF should carefully consider the language to be used in amending its grant agreement with the USMFS with regard to the audit requirements mandated by Section 423 of P.L. 106-74. While we believe that NSF's current grant provision that "The USMFS shall arrange for the conduct of an audit as required by OMB Circular A-133 ..." is clear in requiring an annual A-133 audit, NSF does not agree. Specifically, NSF's position is that this grant provision does not "require annual audits or that the USMFS comply with the OMB Circular A-133." We are concerned with NSF's comment and note that Subpart B, Section 220, *Frequency of audits*, of OMB Circular A-133, requires that audits be performed annually. In addition, we believe that the words, as stated, clearly specify that the OMB A-133 procedures are to be used for such audits. Therefore, in amending its grant provision, NSF must use precise language that it believes will clearly require annual audits and the use of OMB Circular A-133 standards.

USMFS actions are appropriate to begin developing internal control procedures and to obtain advice from an international accounting firm on the requirements of OMB Circulars A-110, A-122, and A-133. While the NSF grant agreement does not require compliance with all three of these OMB Circulars, which establish federal grant administrative and audit requirements and cost principles; two of the USMFS grant agreements with the other federal agencies do include these OMB requirements. Thus, initial USMFS steps taken to obtain an understanding of these OMB regulations are responsive to the audit recommendations and highly commendable.

3. USMFS Needs To Establish Better Controls for Managing the Endowment Fund

The NSF and other federal agency grant agreements did not include consistent provisions for the USMFS endowment management. Specifically, one of the four grant agreements did not require a reserve account to protect the USMFS endowment value against inflation, did not limit endowment investments in U.S. government-backed securities, and did not include endowment dissolutions terms. As such, we found that the USMFS under-funded the endowment reserve account by \$605,345, or 38 percent, of the required balance since 1998 and did not set-aside \$70,000, or one-third, of the annual reserve amounts approved by its Board of Governors (BOG) in 2002. Furthermore, \$2.7 million, or 25 percent, of total U.S. endowment principal and \$560,000, or 78 percent, of the U.S. share of the endowment reserve account were inappropriately invested in corporate bonds and equities instead of U.S. government-backed securities. Additionally, the USMFS had not established dissolution procedures to ensure the U.S. share of the endowment funds would be appropriately handled in accordance with its federal grant agreements.

Consequently, NSF and the other federal agencies had less assurance that the endowment funds were adequately safeguarded from losses due to inflation and risky investments and would be distributed in accordance with federal guidelines if the USMFS were to cease operations. Once again, this occurred because as a new, as well as a foreign organization, the USMFS lacked a clear understanding of its responsibilities to establish a system of internal controls for managing its endowment fund to ensure compliance with its federal agency grant terms and conditions. Thus, it did not develop timely and comprehensive written policies and procedures for managing the endowment fund.

NSF Develops Special Award Terms and Conditions for USMFS Endowment Fund

Due to the unique nature of funding the Congressionally-mandated USMFS endowment fund, NSF developed special terms and conditions for handling the U.S. contributions. The “Funding Arrangement” established the following significant provisions for endowment management:

1. “The USMFS proposes to reinvest a portion of the interest earned from the Endowment in order to protect the value of the Endowment over time.”
2. “The USMFS will invest funds made available to the Endowment by the NSF, or **by other U. S. government agencies**, in U.S. government backed securities.” (emphasis added)
3. “If and when the USMFS dissolves, the U.S. contributions to the Endowment shall be returned to NSF for return to the U.S. Treasury, or distributed in accordance with the by-laws of the USMFS to support activities approved by NSF in consultation with the other contributing U.S. government agencies.”

However, because each of the other federal agencies independently developed their own grant provisions addressing these endowment management issues, the provisions varied between NSF, NASA, EPA, and USDA as follows:

Federal Agency Grant Provisions For USMFS Endowment Fund Management

<u>Agency</u>	<u>Endowment Reserve Required</u>	<u>Investment in U.S. Government Backed Securities Required</u>	<u>Dissolution Terms</u>
NSF	Yes	Yes	Yes
NASA	No	No	No
EPA	Yes	Yes	Yes
USDA	Yes	Yes	Yes

Clearly, the EPA and the USDA had grant provisions consistent with NSF provisions requiring a reserve account to protect the value of the endowment, investment in U.S. government-backed securities, and endowment dissolution terms. However, the NASA grant agreement did not include such provisions.

USMFS Did Not Fully Comply With U.S. Grant Provisions

Yet, the USMFS did not comply with three of the four federal grant agreements prescribing certain requirements for managing and administrating U.S. endowment contributions. Specifically, the USMFS did not correctly compute a reserve amount to protect the endowment’s principal against inflation, fund the approved reserve amount in a timely manner, allocate the annual reserve amounts to each contributing agency equitably, limit the investment of all endowment funds to U.S. government-backed securities, and establish dissolution terms for the endowment principal and/or reserve.⁹

a. Endowment Reserve Account

Pursuant to the current USMFS endowment policies, a reserve account balance “equivalent to the U. S. inflation rate applied to the totality of endowment funds” should be maintained to protect the value of the principal from inflation. USMFS officials stated that they have always used this methodology, but were unable to provide any documentation supporting the annual computation of the reserve amount since the endowment’s establishment in 1998. Notwithstanding the lack of supporting documentation, the BOG approved a total reserve amount through 2003 of \$982,450. However, applying the U.S. consumer price index¹⁰ against the annual endowment

⁹ The USMFS had six separate endowment investment accounts: one for each of the five contributing agencies and one for the reserve funds.

¹⁰ We used the annual Consumer Price Index published by the U.S. Department of Labor multiplied by the total endowment principal to calculate the required reserve amount.

balance for 1998 to 2003, we estimated that the total reserve amount should have been \$1,587,795. Thus, we estimated that the reserve balance was \$605,345, or 38 percent short, of the required balance based on the USMFS' current written endowment policies.

Additionally, although the BOG approved the annual reserve amounts, the USMFS did not always set-aside the full amounts in the reserve account each year. The endowment reserve was not fully funded during 2002 at the BOG approved levels by \$70,000. Of the \$200,000 reserve approved for 2002, \$60,000 was not deposited into the reserve account until January 2003 and the remaining \$10,000 in March 2003. For 2003, the BOG originally approved \$150,000 for the total reserve account, but reduced the amount by \$50,000 in October 2003, three months before year-end, because the USMFS total expenditures were greater than budgeted.

Additionally, the USMFS endowment policies did not specify how the reserve amount would be allocated to each contributing agency. Therefore, the amounts were arbitrarily allocated to each contributing agency and resulted in a significant variance in each agency's contribution to the reserve account in comparison to their proportional share of the endowment principal. For example, NSF contributed 24 percent of total endowment funds, but USMFS records showed that NSF contributed only 12 percent of the reserve amount during the period from 1998 to 2002. Comparisons of each agency's allocated reserve contributions to their total endowment contributions follow:

Agency	USMFS Allocation of Contributions by Agency to Reserve Account for 1998 to 2002	Percentage Contribution to Reserve Account	Agency Contributions to Endowment Principal	Percentage Contribution to Endowment Principal
NSF	\$105,300	11.9 %	\$4,000,000	23.7 %
NASA	\$ 84,000	9.5 %	\$3,000,000	17.8 %
USDA	\$ 87,000	9.9 %	\$1,900,000	11.3 %
EPA	\$109,450	12.4 %	\$2,000,000	11.9 %
Total US	\$385,750	43.7 %	\$10,900,000	64.7 %
CONACyT	\$496,700	56.3 %	\$5,947,368	35.3%
TOTAL	\$882,450 ¹¹	100%	\$16,847,368	100%

The USMFS allocation shows that the U.S. contributors have under-funded the reserve account while CONACyT, in behalf of Mexico, has over-funded the reserve. Specifically, the U.S. agencies have funded 43.7 percent of the reserve, but provided 64.7 percent of the total endowment contributions; while CONACyT has funded 56.3 percent

¹¹ Total reserve funding reported only through 2002 because the USMFS had not prepared allocation of reserve funding by contributing agency for 2003 at the time of our onsite review in December 2003.

of the reserve while its endowment contributions were only 35.3 percent. According to USMFS officials, the allocations were based on cash flow derived from when endowment investments paid their interest earnings during the year. We believe that such an arbitrary allocation methodology was not equitable because the use of a contributor's earnings for the reserve account reduced the amount of funds used for supporting that agency's sponsored projects.

b. Required Endowment Investment in U.S. Government-Backed Securities

Contrary to the NSF "Funding Arrangement" specifically limiting the investment of U.S. contributions from **all federal agencies** to U.S. government-backed securities, the USMFS endowment policies inappropriately allowed for the investment of NASA's contributions in prime investment-grade securities. As such, the USMFS has improperly invested 91 percent of NASA's contribution of \$3 million in "prime investment grade securities" instead of less risky U.S. government-backed securities. As of November 2003, 73 percent of NASA's funds were invested in corporate bonds¹² and 18 percent in equities. According to the USMFS, it did not limit the investment of NASA contributions to only U.S. government-backed securities because the NASA grant agreement did not include the same investment restriction that was required by the three other federal agencies.

Furthermore, we found that the USMFS endowment policies also allowed the investment of endowment reserve funds in a "higher risk portfolio." As such, as of November 2003, the reserve account was invested 36 percent in other fixed income instruments, 43 percent in equities, 8 percent in mutual funds, and only 13 percent in U.S. government-backed securities. Since 64.7 percent of the endowment funds were financed with U.S. contributions, we estimate that the U.S. share of the reserve account was \$719,097. Of this amount, \$157,875 was invested in U.S. government backed securities, with the remaining \$561,222 inappropriately invested in higher risk investments. The USMFS Executive Director stated that the endowment reserve funds were considered USMFS assets and not restricted U.S. endowment funds, thus not subject to the U.S. required investment restrictions.

c. Endowment Dissolution Procedures

The USMFS endowment policies did not include any dissolution terms for the endowment fund. As a result, our analysis of applicable dissolution provisions in various USMFS legal documents revealed inconsistent and potentially conflicting treatment of the U.S. endowment contributions. Three of the four federal grant provisions stated that in the event of USMFS termination, the U.S. share of endowment contributions would either be returned to the U. S. Treasury or distributed in accordance with the by-laws of

¹² Additionally, contrary to USMFS investment guidelines with their brokerage firm, we found that \$444,961 or 17 percent of the NASA purchased bonds were invested in instruments rated below grade A. The investment guidelines state that "The bonds must be investment grade and preferably rated A or better by both Moody's and Standards and Poors." Yet, 17 percent of the value of the bonds was invested in BAA bonds (medium grade) and 7 percent were not rated.

the USMFS to support activities approved by the contributing federal agency. However, the USMFS by-laws state that “In case of dissolution, the property of the Foundation shall be transmitted free of charge to the institution and nonprofit institutions that the Board of Governors determines.” We believe that these two provisions create confusion as to whether the federal agencies or the BOG would have the final decision over disposition and usage of the U.S. share of endowment funds. Alternatively, although not a legal document, the Notes to the USMFS Audited Financial Statements state that upon dissolution, the endowment contributions would be refunded to the different contributing institutions. Further, quite different than the U.S. grant provisions, the CONACyT grant agreement for the USMFS endowment stated that its funds were to be returned to CONACyT.

Also, the BOG Treasurer stated that distribution of the endowment funds to other organizations, as specified in the USMFS bylaws, would not be well advised because under Mexican tax laws, a substantial portion of such distributions would be lost in taxes. Thus, he believed that the best course of action would be to return the endowment funds to the contributing agencies.

Furthermore, neither the U.S. federal agencies or the USMFS had any written policies nor procedures specifying how the more than \$1 million of endowment reserve funds would be handled upon USMFS dissolution. None of the U.S. grant agreements addressed this issue and the USMFS endowment policies also did not deal with this subject. However, the USMFS Executive Director stated that none of the endowment reserve funds would be returned to any of the endowment contributors because, as previously stated, his position is that the reserve funds are USMFS assets and not restricted endowment assets. However, the BOG Treasurer stated that he believed that the reserve amount should be returned to the contributors in proportion to their funding of the endowment principal.

USMFS Endowment Fund Inadequately Protected Against Inflation and Potential Market Losses

Because the USMFS is not fully complying with all federal grant conditions, NSF and the other federal agencies had less assurance that the endowment funds were adequately safeguarded against inflation and potential losses due to market conditions and would be appropriately handled in accordance with federal guidelines if the USMFS were to cease operations. The USMFS’ failure to adequately fund the reserve account compromises the financial capability of the endowment fund to support USMFS activities in the future. If the endowment principal is not adequately protected against inflation by setting aside a sufficient reserve amount annually, future endowment earnings will be diminished and inadequate to support USMFS operations and activities, as originally envisioned. To illustrate, we estimated that annual interest earned on the reserve shortage of \$605,345 would be \$38,742.¹³ As such, the USMFS does not have this amount available annually to fund its current activities because of the shortage in its reserve account. This shortage

¹³ We calculated this amount using 6.4, the overall interest rate earned on the endowment reserve account in 2003.

will continue to increase if the USMFS continues not to adequately fund the reserve amount annually.

Furthermore, the inappropriate investment of 91 percent of NASA contributions and 87 percent of the U.S. portion of the reserve account in corporate bonds and equities, instead of U.S. government-backed securities, exposes U.S. appropriated funds and earned interest to the increased financial risk of the stock market, where profit and most importantly, the principal itself is not guaranteed. Perhaps investment in high-grade corporate bonds and preferred stock are considered a conservative investment portfolio by the USMFS and other non-government organizations, but such investments are not appropriate for U.S. government funds. In the absence of clear express authority by the NASA grant provisions to invest in more speculative financial instruments, normal fiduciary guidance articulated by the other U.S. agencies would dictate investment in U.S. government-backed securities, where the U.S. contributions would always be protected against market losses.

Additionally, without established USMFS dissolution terms for the endowment funds, there is increased risk that the \$10.9 million in U.S. endowment contributions will not be returned or used by the USMFS for activities or purposes acceptable to the contributing federal agency. Equally important, it is unclear whether NSF or the other federal agencies would receive return of a proportionate share of the endowment reserve account or have any management oversight over its disposition if the USMFS were to cease operations. As of November 2003, the reserve account had a value of \$1,111,434, of which the NSF share was \$263,410 and the total U.S. share was \$719,097.

USMFS Lacks Adequate Written Endowment Management Policies and Procedures

As previously stated, as a new and foreign awardee, the USMFS lacked a clear understanding of the need to establish written policies and procedures for managing its endowment fund to ensure full compliance with its federal grant terms and conditions. As such, although the endowment fund had been established for over five years, the USMFS had only recently established any written management guidance. Specifically, the new policies and procedures were drafted in November 2003, immediately prior to our onsite review, and approved by its Board of Governors in April 2004. While the written procedures are a positive step, our review of the new endowment policies disclosed that there are several significant issues that were not properly or adequately addressed.

First, with respect to the endowment reserve, the USMFS needed to comply with its policy to set-aside an annual amount “equivalent to the U. S. inflation rate applied to the totality of endowment funds.” Prudent business management practices would also dictate that the procedures should further (i) require the calculation of the annual reserve amount be documented, (ii) specify how and why the BOG approved annual reserve amounts could be deferred and/or adjusted, (iii) provide an equitable allocation methodology for the annual reserve amounts to each endowment contributor, and (iv) specify how the endowment reserve funds would be treated upon USMFS dissolution. Similarly, the

procedures also needed to establish clear dissolution terms for the endowment principal itself as well.

Furthermore, we believe that USMFS endowment policies need to be revised to limit the investment of all U.S. endowment contributions, including NASA's contributions, in U.S. government-backed securities as required by the NSF grant provision. We do not believe that the absence of a specific NASA grant restriction necessarily authorized the USMFS to invest these U.S. appropriated funds in non-U.S. government-backed securities. Likewise, the absence of specific federal grant provisions also did not authorize the investment of the U.S. share of the endowment reserve amounts in higher risk financial instruments.

NSF needs to take this opportunity to coordinate with the NASA, EPA, and USDA to identify and discuss each agency's views on the appropriate requirements for USMFS management of the endowment fund. Such efforts will result in consistent U.S. federal government requirements for endowment management and provide additional clarification to the USMFS on how those requirements need to be met. Most importantly, this will provide NSF with both the opportunity and the required information, based on a thorough evaluation of all relevant information, to evaluate any changes in its own award terms and conditions for the USMFS endowment.

Of particular importance, the agencies need to establish requirements for the endowment reserve funds. The USMFS Executive Director clearly takes the position that these funds are USMFS assets and not endowment assets. Thus, the funds are not subject to any of the U.S. endowment grant requirements and will not be returned to the U.S. Government if the USMFS were to cease operations. However, NSF grants and program officials do not agree with the USMFS position that these are not endowment assets. The reserve funds are derived from endowment earnings and set-aside from monies that the contributing federal agencies directed to be used for sponsored projects and/or USMFS operational costs. The reserve funds are not intended to establish a separate private endowment fund for the USMFS.

Recommendations

We recommend that the Director, OISE in consultation with the Director, DGA and Director, DIAS:

- 3.1 Coordinate with NASA, EPA, and USDA officials to develop consistent U.S. federal government requirements for the USMFS endowment with regard to the reserve funds, specific investment requirements, and dissolution terms for the endowment principal and reserve funds.
- 3.2 Evaluate the need for changes in the NSF grant terms and conditions for the USMFS endowment fund based on the results of recommendation 3.1 above.

We recommend that the Director, DGA, in consultation with the Director, OISE, require the USMFS to improve its internal controls over endowment management to ensure compliance with its NSF grant agreement as follows:

- 3.3 Comply with its current procedures to compute the annual endowment reserve amount using the U.S. inflation rate. Develop additional written policies and procedures to ensure that the approved reserve amount is fully funded annually and the annual reserve contributions are equitably allocated to each contributing agency.
- 3.4 Revise its endowment procedures to limit the investment of all U.S. endowment contributions, including the NASA funds and the U.S. portion of the reserve account, to U.S. government-backed securities.
- 3.5 Establish clear disposition terms for the endowment principal and the reserve funds in the event of USMFS dissolution. Such procedures should clearly specify that the reserve funds are restricted endowment assets and not USMFS assets.

NSF Comments

NSF rejects audit recommendations 3.1 and 3.4, but generally accepts recommendations 3.2, 3.3, and 3.5. Specifically, NSF rejects recommendation 3.1 and 3.4 because it states that the Foundation does not have the authority over funds provided to the USMFS by other Federal agencies and it is not appropriate for NSF to dictate to other agencies how their award agreements should be structured. Furthermore, NSF plans to delete all current grant provisions referencing endowment contributions made by the other federal agencies.

With regard to recommendations 3.2, 3.3, and 3.5, NSF states it will seek to obtain appropriate amendments of its grant agreement to clarify directions on the disposition of NSF-provided funds, with respect to the endowment, the reserve, and interest earnings, upon dissolution of the USMFS. In particular, for recommendation 3.3, NSF will attempt to amend the grant agreement to require the USMFS to use the U.S. inflation rate in calculating reserves for interest earnings, but only for NSF-provided funds.

USMFS Comments

The USMFS states that the facts presented in the audit report are accurate, but does not state its position on the audit conclusions and recommendations. Nevertheless, it agrees to work with NSF and the other federal agencies to develop and implement corrective actions resulting from the audit recommendations.

OIG Response

Although NSF cannot dictate to the other federal agencies how their award agreements should be structured, we continue to believe that coordinated efforts are essential in developing consistent U.S. requirements for endowment management to protect not only

NSF's \$4 million contribution, but also the remaining U.S. contributions of \$6.9 million. Since the USMFS endowment management policies and procedures will be based on such federal requirements and will affect all U.S. federal agency contributions, we reaffirm recommendation 3.1.

In addition, with regard to recommendation 3.4, NSF should not delete the current NSF grant provision requiring the investment of all federal agency endowment contributions in U.S. government-backed securities, without first discussing the potential effect of such a proposed change with the other federal agencies. This NSF grant provision could be instrumental in requiring the USMFS to invest all federal agency endowment contributions in more conservative U.S. government-backed securities rather than more speculative financial instruments such as corporate bonds and stocks. Typically, normal fiduciary guidance articulated by the Federal Government stipulates that U.S. appropriated funds should only be invested in these more speculative financial instruments when there is clear express authority to do so. However, there was no such provision in any of the four federal agency grant agreements for funding the USMFS endowment.

Furthermore, to fully implement recommendation 3.4, NSF also needs to establish investment requirements for the reserve funds. Specifically, as of November 2003, over 78 percent, or almost \$206,000, of NSF's portion of the reserve funds was inappropriately invested in non-U.S. government-backed securities, where profit and most importantly, the principal is not guaranteed. Of this amount, over 50 percent was invested in corporate stocks or mutual funds.

With regard to recommendations 3.2, 3.3, and 3.5, NSF proposed actions to negotiate amendments to its award agreement to require the USMFS to use the U.S. inflation rate in calculating the endowment reserve amount annually and to clarify requirements on the disposition of NSF-provided funds are appropriate. However, to fully implement audit recommendation 3.3, NSF must also require the USMFS to establish procedures for equitably allocating the reserve to each contributing agency. Although the current USMFS process has favored NSF to date, by allocating only 12 percent of reserve requirements to NSF versus its 24 percent share of total endowment contributions, the USMFS could change such a process at any time. Without established written procedures, it is possible that in the future, NSF and/or other U.S. federal agency endowment interest could be disproportionately allocated to funding the reserve account rather than to bi-national science and technology related project activities, which are the major purpose of the U.S. endowment funding.

**The United States Mexico Foundation for Science
Format A-133 FY 2002**

Total Funds Applied to Projects

Source Funds	Balance Starting	Total Interest 2002	Amount Invested in Reserve	Total Available	Percentage	Assigned to Projects	Endowment interests used for Programs Development	Endowment interests used for Administrative Expenses	Endowment interests used for Board of Governors	Total Assigned	Balance to 31/12/02
N.S.F.	29,044	244,912	45,300	228,656	19.90%	94,081	102,913	5,543	3,344	205,881	22,776
N.A.S.A.	26,627	178,734	14,000	191,361	16.66%	77,930	86,128	4,639	2,799	171,495	19,866
U.S.D.A.	8,722	113,866	12,000	110,588	9.63%	41,633	49,771	2,680	1,617	95,701	14,887
E.P.A.	1,353	127,887	24,000	105,240	9.16%	57,631	47,366	2,551	1,539	109,087	-3,847
Total Estados Unidos	65,746	665,399	95,300	635,845	55.34%	271,274	286,177	15,414	9,299	582,164	53,681
CONACYT	46,088	571,644	104,700	513,032	44.66%	214,887	230,910	12,504	7,571	465,872	47,160
Total Funds	111,834	1,237,043	200,000	1,148,877	100%	486,161	517,087	27,918	16,870	1,048,037	100,840

Total Project Expenses

Projects	Amount	NSF	NASA	USDA	EPA	Total from U.S. Sources	CONACYT	Verification *
Summer Fellowships	37,744	11,145	9,744	0	0	20,889	16,855	37,743
Megacities pollution	55,171	10,980	9,189	0	10,364	30,533	24,637	55,170
Water and Health	42,683	0	0	4,108	19,514	23,622	19,060	42,682
Industry University Coop. For Clean Production	25,812	5,137	4,299	2,484	2,364	14,285	11,526	25,811
Food Safety	23,329	0	0	12,911	0	12,911	10,418	23,329
Migrant Health	25,700	5,115		2,474	6,635	14,223	11,476	25,699
Environmental Health Network	43,813	8,720	7,297	4,217	4,013	24,247	19,565	43,812
Science.Tech. And Border	15,367	4,466	2,560	1,479		8,505	6,862	15,367
Specialist Training in Environmental Health	7,161	1,425	1,193	689	656	3,963	3,198	7,161
Crossborder	58,871	11,717	9,806	5,666	5,393	32,581	26,289	58,870
Binational Science Education	56,707	16,744	14,639	0	0	31,383	25,323	56,706
Visiting Scientists	9,852	2,909	2,543	0	0	5,452	4,399	9,852
Strategic Planning	18,742	3,730	3,122	1,804	1,717	10,372	8,369	18,742
Nasa	27,055	5,384	4,506	2,604	2,478	14,973	12,081	27,054
New Border Water Project	4,955	0	3,500	0	1,455	4,955	0	4,955
Outreach	33,209	6,609	5,531	3,196	3,042	18,379	14,829	33,208
Total Projects	486,171	94,081	77,930	41,633	57,631	271,274	214,887	486,161

1.- Program Development Expenses	517,098
2.- Administrative Expenses	75,108
3.- Board of Governors Expenses	64,060
4.- Total Expenses (Sum 1+2+3)	656,266
5.- Overhead charged to third party projects	94,212
6.- Total Expenses covered by the Endowment	562,053.70
7.- Percentage of Interest generated by Endowment from U.S.	55.34%
8.- Portion of Expenses covered by Endowment from U.S.	311,057.38



NATIONAL SCIENCE FOUNDATION
4201 Wilson Boulevard, Arlington, Virginia 22230

November 1, 2004

Office of International Science and Engineering

**MEMORANDUM TO [REDACTED], SENIOR AUDIT MANAGER,
OFFICE OF INSPECTOR GENERAL (OIG)**

From: [REDACTED] [REDACTED]
[REDACTED] Office of International Science and Engineering (OISE)

Subject: Response to Draft Report on Audit of the United State-Mexico Foundation for Science (USMFS)

Enclosed you will find the coordinated agency response to the Draft Report on Audit of the United States-Mexico Foundation for Science.

I want to thank you for granting the time extension to the USMFS and us to be able to better coordinate our response. Should you have any additional concerns please let me know.

Attachment

cc: [REDACTED]
Directorate for Social, Behavioral and Economic Sciences (AD/SBE)

[REDACTED]
Division of Grants and Agreements (BFA/DGA)

[REDACTED]
Division of Institutional and Award Support (BFA/DIAS)

[REDACTED]
Office of Legislative and Public Affairs (OD/OLPA)

[REDACTED]
Office of the General Counsel (OD/OGC)

DRAFT

Response to the Draft Report on Audit of the United States-Mexico Foundation for Science (USMFS)

NSF management finds this Draft Audit Report very useful, but does not agree with its conclusion that NSF, as the major contributor to the Endowment, should take the lead to get the other three federal agencies to enforce the provisions of Public Law 106-74 for the entire U.S. Government. NSF lacks the authority to do so, since there is no agreed legal relationship between the NSF and the other three agencies vis-à-vis the USMFS. Each agency has an independent relationship with the USMFS.

Since NSF can only accept responsibility for its own actions in relation to the USMFS as specified in its “Funding Arrangement”, we must reject the recommendations (1.1, 2.1, 3.1, and 3.2) that NSF work with other interested Federal agencies (specifically the Office of Science and Technology Policy, Departments of Agriculture and State, Environmental Protection Agency, and National Aeronautics and Space Administration) to determine what actions are necessary regarding the endowment of the George E. Brown United States/Mexico Foundation for Science or take actions to affect funds provided by other agencies (3.4) . If OSTP or DOS address this matter on a government-wide basis or one of the three other funding agencies asks us for help, naturally we will assist them.

Instead, NSF will negotiate an amendment of its “Funding Arrangement” with the USMFS, to comply with the requirements of Section 423 of Public Law 106-74, as quoted in the Draft Audit Report, as it pertains to the NSF vis-à-vis the USMFS exclusively. This will involve deleting reference to the other agencies from the financial arrangements (that is, contributions to the Endowment); introducing the administrative and audit requirements specified in P.L. 106-74; and (if possible) providing for the renaming of the USMFS. The issue of matching funds is already integral to the “Funding Arrangement” and thus is not an issue for NSF. The issue of renaming the USMFS as the George Brown Memorial Foundation may require negotiation with Mexican authorities and thus exceed the authority of the NSF. Consequently, we accept the remaining recommendations (1.2, 2.2 through 2.5, 3.3, and 3.5) except those suggesting that NSF coordinate its actions with other agencies or enforce their participation. The Division of Institution and Award Support will take prompt action to negotiate necessary changes to the “Funding Arrangement”.

The above statements clearly summarize the NSF response, however, as requested by the Office of the Inspector General a point-by-point reply on each of the recommendations, is presented below.

OIG Recommendation 1.1 –That OISE in consultation with OGC and OLPA formally notify OSTP of the non-compliance with the three mandatory requirements established in Section 423 of P. L. 106-74 and propose that OSTP coordinate corrective efforts.

Agency Response – NSF rejects this recommendation both because it would inappropriately have us take the lead in this matter and because the Office of Inspector General has already provided OSTP a copy of this draft audit report, making a formal notification unnecessary.

OIG Recommendation 1.2 -- That DGA amend the NSF “Funding Arrangement” to ensure that endowment contributions are managed in full compliance with Section 423 of P. L. 106-74,

Agency Response – DGA will engage in negotiations with USMFS to amend the award to implement the statutory requirements in respect to NSF funding. To the extent that this recommendation would have NSF seek to assure compliance for all United States Government-provided endowment funds, we reject it as exceeding our authority.

OIG Recommendation 2.1 – That OISE coordinate with NASA, EPA, and USDA to clarify US Government requirements for project cost accounting systems for endowment earnings expenditures.

Agency Response - NSF rejects this recommendation because it would inappropriately have us take the lead in this matter.

OIG Recommendation 2.2 – That DGA & DIAS require USMFS to improve internal controls and establish written policies and procedures for salary and travel expenses (Specifically airfare should be limited to economy class).

Agency Response - DGA will engage in negotiations with USMFS to amend the award to implement the statutory requirements in respect to NSF funding. The NSF Funding Arrangement, Section VII (B) travel costs, already requires that airfare not exceed economy travel.

OIG Recommendation 2.3 – DGA & DIAS provide clarification on required reporting of annual fiscal report of endowment interest expenditures.

Agency Response - The NSF Arrangement (Section V – Reporting requirements) requires a fiscal report of contributions, interest earned, and a program activity report. These fields appear to be included in the Exhibit one. In addition, USMFS provides annual reports to NSF outlining program activities and posts annual reports to the USMFS website. If the NSF program officer requires additional reports or details from

USMFS he/she can contact USMFS directly or utilize section C – audits and records - of the funding agreement to obtain more detailed financial information.

OIG Recommendation 2.4 – DGA & DIAS direct USMFS to arrange for A-133 audits annually.

Agency Response - The Funding Arrangement Section C (5) states “The USMFS shall arrange for the conduct of an audit as required by OMB Circular A-133, ‘Audits of Higher Education and Other Non-Profit Organizations.’” The USMFS shall provide a copy of the report of this audit to NSF.” The agreement did not require annual audits or that USMFS comply with OMB Circular A-133. USMFS did have an A-133 audit report conducted and did provide a copy of this report to NSF. As the auditors state on page 3 of the audit report, “Without requiring USMFS to adhere to US grant requirements (A-122 and A-110), the usefulness of the annual A-133 would be of limited value to NSF.”

OIG Recommendation 2.5 – DGA & DIAS provide technical assistance to USMFS to ensure staff understands federal grant requirements and that experienced auditors are engaged to perform A-133 audits.

Agency Response - If the award terms and conditions are amended to include Office of Management and Budget Circular A-122, Cost Principles for Non-Profit Organizations, and part 215 of title 2 of the Code of Federal Regulations (formerly Office of Management and Budget Circular A-110, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations), DGA and DIAS will consider arranging an on-site visit to USMFS under the Award Monitoring and Business Assistance Program.

OIG Recommendation 3.1 – INT coordinate with NASA, EPA, and USDA officials to develop consistent requirements on the USMFS endowment regarding: reserve funds, investment requirements, and dissolution terms for the endowment principal and reserve.

Agency Response – NSF rejects this recommendation because it would inappropriately have us take the lead in this matter.

OIG Recommendation 3.2 – That OISE evaluate the need for changes in the NSF grant terms and conditions for the USMFS endowment fund based on the above.

Agency Response - To address the concerns expressed in this Audit Report, DGA, with the advice of OISE, will seek to obtain appropriate amendments to the Funding Agreement, including clarified directions on the disposition of NSF-provided funds -- endowment, reserve, and interest earning -- upon dissolution of USMFS.

OIG Recommendation 3.3 – That DGA require USMFS to use the US inflation rate when computing the annual reserve amount and require USMFS to develop written procedures and equitably allocate reserve to each contributing agency.

Agency Response – DGA will seek to obtain an amendment to the Funding Agreement mandating that USMFS use the US inflation rate in calculating reserves of interest earnings. That requirement, however, can apply only to NSF-provided funds.

OIG Recommendation 3.4 – That DGA require USMFS to limit investment of all US endowment funds to US Government backed securities.

Agency Response - NSF rejects this recommendation because it has no authority over funds provided to USMFS by other Federal agencies. The NSF funding arrangement did contain this requirement and, based on the audit report, USMFS complied with this requirement for the funds provided by NSF. NSF did not develop nor is NSF responsible for the terms of the agreements developed by the other funding agencies. It is not appropriate for NSF to dictate to other Federal agencies grants and agreements offices how their award agreements should be structured.

OIG Recommendation 3.5 – That DGA require USMFS to establish clear disposition terms for the endowment principal and the reserve funds. Reserve funds should be clearly designated as endowment assets not USMFS assets.

Agency Response - As stated in response to an earlier recommendation (3.2), DGA, with the advice of OISE, will seek to obtain amendments to the Funding Agreement clarifying the disposition of NSF-provided funds -- endowment, reserve, and interest earning -- upon dissolution of USMFS.



The United States-Mexico Foundation for Science
Fundación México-Estados Unidos para la Ciencia

Board of Governors

October 26, 2004

[REDACTED]
Senior Audit Manager
National Science Foundation

Reference:

- Office of Inspector General (NSF) Draft audit report and letter dated September 3, 2004

Dear [REDACTED]

Thank you for providing the United States - Mexico Foundation for Science (FUMEC) with the opportunity to review and respond to the Office of Inspector General's ("OIG") draft audit report "Audit of United States-Mexico Foundation for Science." We also thank you for granting FUMEC until November 1, 2004 to provide its response to this draft audit report. This allowed FUMEC's Board of Governors to review and discuss thoroughly the draft report at its October 1&2, 2004 Board meeting, as well as, did the appropriate consultations afterwards. Finally, thank you for granting FUMEC and its staff the opportunity to provide information to you during your review. We hope that all of your questions were answered completely and to your satisfaction.

FUMEC's Board of Governors, its management, and its staff have carefully reviewed the draft report of the Office of Inspector General's (OIG) audit of the Foundation and your September 3, 2004 transmittal letter. Your transmittal letter asked us to address the findings and recommendations in the draft report and to identify any factual



The United States-Mexico Foundation for Science Fundación México-Estados Unidos para la Ciencia

Board of Governors

inaccuracies in the draft report. Addressing the latter issue first, we believe the facts stated in the draft report are generally accurate.

With respect to the findings and recommendations, it appears that the specific recommended corrective actions are directed at NSF and the other agencies. We stand ready to provide NSF with any information or assistance they may need in responding to the draft audit report. We also will work with them to develop and implement corrective actions, if any, resulting from OIG's recommendations.

In addition to being prepared to work with the NSF on moving forward in developing and implementing corrective measures, FUMEC has already taken a number of steps to prepare for this process. First, FUMEC's Board of Governors, management, and staff have reviewed the draft report extensively and have a strong appreciation for the concerns and recommendations raised in the draft report.

Also, FUMEC has begun the process of developing and implementing appropriate internal controls and procedures consistent with any new specific requirements which may be implemented if our grant agreements with the agencies are revised. Specifically, FUMEC has retained a U.S. law firm [REDACTED] with extensive experience in U.S. Federal grant and contract law. FUMEC has also retained an accounting firm with experience in Mexican accounting procedures, which is being advised by an international accounting company on the requirements of the relevant U.S. laws and regulations including OMB Circulars, A-110, A-122, and A-133.

Based on the observations and comments of the draft audit report and any further corrective measures which might be negotiated with the NSF and/or the other agencies, FUMEC will act to improve its relevant internal procedures and controls.

FUMEC, and especially the Board of Governors, greatly appreciate not only the granting of the extension of time for the response to the draft audit report, but the continuing close working relationship. We thank you

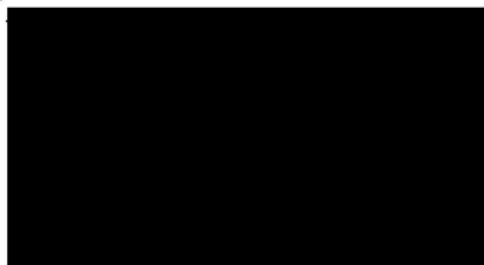
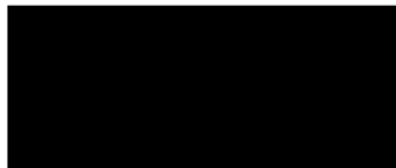


The United States-Mexico Foundation for Science
Fundación México-Estados Unidos para la Ciencia

Board of Governors

for the opportunity to respond and we reassure you that audit reports are taken very seriously and the review process continues to be precise, transparent, proper and takes into account the complexities associated with the successful operation of the Bi-National nature of this important enterprise.

Sincerely yours,



CC:

