AUDIT REPORT

NATIONAL AIR AND SPACE MUSEUM
MALL SIMULATORS

A-04-10

February 25, 2005

Smithsonian Institution

Office of Inspector General

SUMMARY

The Office of the Inspector General audited the financial performance of the Smithsonian Business Ventures flight simulators operated by a contractor at the National Air and Space Museum on the National Mall. Smithsonian Business Ventures requested this audit because of concerns with the operation of the simulators. Our purpose was to determine whether Smithsonian Business Ventures had adequate controls in place to ensure that revenues and expenses from those simulators were at expected levels, and that funds due Smithsonian Business Ventures from the contractor were received and promptly reported and recorded in the official accounting records. Also, we determined if the net income from these simulators was being used as planned to repay funds advanced to construct the Steven F. Udvar-Hazy Center, an annex to the National Air and Space Museum.

We found that funds due Smithsonian Business Ventures from the contractor were eventually received. However, improvements were needed in four areas: (1) contractor selection procedures, (2) accounting and reporting procedures, (3) payment of utilities expenses, and (4) receipt of special event revenues. We therefore made the following recommendations to management to improve controls:

- Develop and implement written contractor selection procedures to identify needs more precisely in requests for proposals and to define and prioritize contractor selection and evaluation criteria.
- Develop and implement policies and procedures to review and record accounting entries in accordance with generally accepted accounting principles.
- Institute accounting training for personnel entering accounting data into the Lawson system.
- Refine responsibilities for payment of utilities expenses in the Memorandum of Agreement between Smithsonian Business Ventures and the Office of Facilities Engineering and Operations.
- Develop and implement written procedures for Smithsonian Business Ventures to accurately record and promptly follow up on intra-institutional receivables, with particular regard to special event revenues due Smithsonian Business Ventures from the National Air and Space Museum.

Office of the Inspector General

TABLE OF CONTENTS

ABBREVIATIONS AND ACRONYMS

FAR	Federal Acquisition Regulation
GAAP	Generally Accepted Accounting Principles
NASM	National Air and Space Museum
OC	Office of the Comptroller
OFEO	Office of Facilities Engineering and Operations
OGC	Office of General Counsel
RFP	Request for Proposal
SBV	Smithsonian Business Ventures

INTRODUCTION

A. Purpose

The purpose of the audit was to determine whether the monthly proceeds from contractor operation of flight simulators at the National Air and Space Museum (NASM) on the National Mall have been properly received and reported to Smithsonian Business Ventures. Smithsonian Business Ventures (SBV) requested this audit because of concerns with the operation of the simulators.

B. Scope and Methodology

The audit was conducted from August 10, 2004, to October 26, 2004, in accordance with generally accepted government auditing standards. We evaluated and tested the adequacy of the controls and procedures over the collection, remittance, reporting, accounting, and contractual requirements related to the operation of the flight simulators at the National Air and Space Museum on the mall.

The audit covered business activity from March 31, 2002, to June 30, 2004.

We reviewed the following:

- NASM mall simulator contract;
- Accounting policies and procedures relating to the simulators;
- Prior audits and investigations of Smithsonian activities and of similar activities from other federal and local government agencies;
- Daily, weekly, and monthly transactions for the period March 31, 2002, through June 30, 2004; and
- Revenue collection processes for the simulators, from the receipt of the cash to the deposit in the bank and recording in the Lawson financial accounting system.

We interviewed staff from offices involved with the simulators, such as the Office of the Treasurer, NASM, SBV, and the Office of Facilities Engineering and Operations (OFEO). We also met with the contractor's senior management in Tom's River, New Jersey. We reviewed the contractor's records on-site in New Jersey to determine if their reported revenues and expenses were supported by their corporate records. Through interviews and transaction reviews, we evaluated contractor practices and controls over accounting, contracting, and operations.

During the audit, we sought to answer questions such as:

1. Did the contractor remit the agreed net revenue percentage promptly and accurately to SBV?
2. Did the contractor report revenue and expenses and net revenue promptly and accurately to SBV?
3. Were revenues and expenses accurately and promptly recorded in the accounting records of both SBV and the simulator contractor?

4. Were SBV and contractor expenses supported by documents such as purchase orders and invoices?
5. Was there good communication of accounting and management information between the contractor and the Institution?
6. Did SBV and the contractor comply with relevant contract terms, policies and procedures, and laws and regulations?
7. Were SBV's contracting procedures adequate?

C. Background

The simulators opened on March 31, 2002. The simulators are located in Exhibit Hall 103 of NASM on the National Mall at the west end of the museum. The simulator rides cost $6.50 per person for a three-minute ride. The simulators operate daily from 10:00 A.M. to 5:30 P.M.

The simulators are managed by the Smithsonian Business Ventures. SBV used a contractor to manufacture and operate the flight simulators at NASM. The contractor currently operates fourteen two-seat full motion interactive ride flight simulators.

The simulator contractor is responsible for the collection, handling, transporting, security and deposit of all funds collected from the simulator rides. The simulator contractor remits a portion of the funds to SBV based on the contract terms.

SBV records the net revenue from the simulator activities into their accounting system, Lawson. At year-end, the accounting information from the Lawson system is consolidated into the Institution's PeopleSoft system.

Each year, SBV provides the Institution's Office of the Treasurer fifty percent of the adjusted net gain from the simulator ride sales. The adjusted net gain is calculated by reducing the net income from the simulator operation by the amount of selected SBV general and administrative expenses, specifically expenses for management information systems, office management and the Museum Retail Division. The transfer of funds to the Office of the Treasurer is used to pay back the advance funds borrowed by NASM to construct the Steven F. Udvar-Hazy Center in Virginia.

For the period from March 31, 2002, to June 30, 2004, according to SBV's accounting records, the simulators produced net income of approximately $529,497 from operations.

RESULTS OF AUDIT

A. Contractor Selection Procedures

SBV, with the participation of the Office of General Counsel (OGC), did not follow best practices of contractor selection in three respects: evaluation of the contractor's financial and operational capabilities; specification of the various factors affecting the contract award and their relative importance in the request for proposal (RFP); and specification of SBV's needs in the RFP. SBV did not have procedures for evaluating the contractor's financial health and operational capabilities. SBV also lacked written contractor selection procedures. SBV's contracting practices also lacked key controls, such as the requirement to define their needs. Financial and operational weaknesses resulted from a combination of these conditions and from a reduction in the number of visitors due to the terrorist attacks of September 11, 2001; the contractor's difficulty obtaining long-term financing; the less than desirable location of the simulators in the museum; and the two-month opening delay. The contractor developed a severe cash-flow problem and failed to remit approximately $250,000 to SBV from April 1, 2002, to November 22, 2002. SBV took proactive steps and recovered these funds by the first quarter of 2003.

Background

In a 2000 audit report, the Office of the Inspector General recommended that SBV develop written contracting procedures, and SBV management agreed to implement written procedures by August 2002. SBV still had not implemented written contracting procedures at the time of this audit. Since SBV lacked written contracting procedures, we reviewed best contracting practices used by industry and the federal government.

Industry and federal government requirements are very similar with respect to contractor selection procedures. A cursory review of private sector resources available on the Internet revealed several instances of best practices. As a sample, we compared RFP forms from IBM's technical sales library, the American Institute of Architects (AIA) Contractor Qualification Statement, and the Federal Acquisition Regulation (FAR). We identified the following common contractor selection requirements in those three sources: (1) confirmation that sufficient financial resources are available to the contractor to perform the contract; (2) review of prior performance by the contractor; and (3) evaluation of the contractor's experience and technical skills. The IBM sample RFP and the FAR also share the following additional requirements: identification and statement of the needs of the purchaser; and disclosure of selection criteria and their relative importance. (The AIA form did not have these requirements because they do not apply solely to the qualification of contractors.)

Results

SBV, with the participation of OGC, did not follow best practices of contractor selection in its evaluation of the contractor's financial and operational capabilities; its identification of the various factors affecting the contract award and their relative importance in the RFP; or its specification of SBV's needs in the RFP.

SBV lacked written contractor selection procedures. SBV did not document whether the contractor (a) had, or had the ability to obtain, the financial resources necessary to perform the contract, (b) had a satisfactory performance record, or (c) had the necessary experience and technical skills. SBV reviewed the contractor's Dunn and Bradstreet report but did not conduct a thorough financial analysis to determine whether payment for manufacturing the simulators would strain the contractor's cash flow and increase risk.

In the RFP, SBV did not include the factors to be considered in awarding the contract and their relative importance to price. SBV instead simply said in the RFP that financial performance would be one of several factors to be evaluated, and did not further explain what those factors would be. When the RFP was being developed, neither SBV nor the Institution had expertise in simulator attractions. SBV and OGC requested the contractors provide them with the types of simulator rides available.

SBV did not have procedures for evaluating the contractor's financial health and operational capabilities. SBV management told us the quality of the flight experience provided by the contractor's simulator was a more significant factor than other factors. SBV management told us they believed that the contractor selected provided the best simulation of a flight, which would translate into increased sales and profitability. They also said that because there was a limited number of contractors that could provide the best "flight experience," it was difficult to minimize the risks of contractor financial health and operational performance.

SBV's contracting practices also lacked key controls, such as the requirement to define their needs. Additionally, SBV did not have procedures which required SBV to specify in the RFP the needs to be filled or the intended goals of the simulator program. Instead, SBV's needs were determined by reviewing the responses to the RFP.

Another key control missing from SBV contracting practices is the requirement to document the evaluation of the offerors' capabilities. Because SBV did not document the review of the offeror's capabilities and several key people involved in the evaluation are no longer at the Institution, it was difficult for us to assess the results of their evaluation. Based on our conversations with SBV we found that SBV did not properly weigh the fact that the contractor had never operated flight simulators for profit, but was solely a manufacturer and servicer of the machinery. SBV did not examine whether the contractor would have the technical and management skills necessary to operate the simulator in a for-profit environment.

SBV did not include the factors affecting the contract award and their relative importance in the RFP because there were no written contract procedures. Also, there were no written contract procedures which required SBV to include in the RFP the evaluation factors' relative importance to price. Financial performance and the best overall business arrangement for the Institution were the only criteria specifically enumerated in the RFP, but state-of-the-art machinery and providing the best flight experience were the most heavily weighted factors actually used in selecting this contractor.

Financial and operational weaknesses resulted from a combination of these conditions, as well as from a reduction in the number of visitors due to the terrorist attacks of September 11, 2001; the contractor's difficulty obtaining long-term financing; the less than desirable location of the simulators in the museum; and the two-month opening delay. The contractor developed a severe cash-flow problem and failed to remit $250,000 to SBV from April 1, 2002, to November 22, 2002. SBV took proactive steps and recovered these funds by the first quarter of 2003.

Conclusion

SBV performed a limited analysis of the financial health of the contractor. The contractor was initially unable to make payments to SBV and perform other terms of the contract. Also, the contractor had no experience operating a concession in a for-profit environment, and several incidents occurred because of the lack of this experience. SBV did not adequately address the above issues when selecting this contractor. SBV should (a) identify the needs to be fulfilled by the contract prior to issuing the RFP, (b) evaluate whether proposed contractors have: (i) adequate financial resources to perform the contract, or the ability to obtain them, (ii) a satisfactory performance record, and (iii) the necessary experience and technical skills; and (c) include the factors affecting the contract award and their relative importance in the RFP. Also, the procedures should require the RFP to include the evaluation factors' relative importance to price.

Recommendation

We recommended that the Chief Financial Officer of Smithsonian Business Ventures develop and implement written contractor selection procedures to identify needs more precisely in requests for proposals and define and prioritize contractor selection criteria.

Management Comments

Concur. Smithsonian Business Ventures recognizes the need to develop and implement appropriate written contractor selection procedures and will develop and implement these procedures by March 1, 2006.

Smithsonian Business Ventures relied on the support of the Office of General Counsel and the Office of Contracting for legal and contract work. Smithsonian Business Ventures defined the Institution's needs by asking the potential contractors for their best proposal based upon on the advice of the Office of General Counsel. Smithsonian Business Ventures agreed that greater analysis could have been applied to the review of the vendor's financial health. However, Smithsonian Business Ventures does not believe the review of the vendor's financial health would have revealed the vendor's vulnerability to economic downturns caused by the September 11 attacks or the vendor's inability to obtain long-term financing.

Office of the Inspector General's Response

Smithsonian Business Ventures management would have had a better understanding of the risks involved in this contract if it had thoroughly reviewed the vendor's financial condition. If a vendor's financial condition is weak and the economy declines, the vendor and its customers are exposed to increased financial and operational risks.

B. Accounting and Reporting Procedures

SBV did not properly account for revenues, bad debt, or depreciation expenses and accumulated depreciation for the simulators. SBV understated simulator revenue by approximately $166,000, approximately one-half of total 2003 revenue. SBV reported bad debt expense of $136,979 for the fiscal year ended 2002, but SBV could not provide us a basis for their calculation. SBV also understated the amount of depreciation expense recorded into the depreciation expense account by approximately $131,069 from April 1, 2002, to June 30, 2004. SBV had also overstated the amount of accumulated depreciation by $80,656. These conditions occurred because SBV lacked written accounting policies and procedures and did not review accounting entries for the simulators. SBV management told us that review of these accounting entries was not a priority because of the relatively less significant business operations involved. However, the lack of accurate accounting information increases the risk of improper management decisions, decreases control, and increases the risk of loss.

Background

SBV manages small businesses for the Institution and generates trust fund revenues from these activities. We reviewed the accounting for simulators, which are accounted for similarly to other concession activities, such as food services. SBV accounts for the simulator operation as follows: revenues are entered from a monthly accounting report provided by the contractor. SBV uses this report to manage the contractor and assess its operations. Additionally, SBV accounts for its own simulator-related expenses by making entries into the Lawson accounting system.

Smithsonian Directive 115, *Management Controls,* requires policies and procedures to ensure that reliable data are obtained, maintained, reported, and used for sound decision-making. Specifically, it states that, “Key duties and responsibilities in authorizing, processing, recording, and reviewing official agency transactions should be separated among individuals. Managers should exercise appropriate oversight to ensure individuals do not exceed or abuse their assigned authorities.” Accounting supervisors should review journal entries to ensure they reflect generally accepted accounting principles (GAAP) and are complete and accurate. The supervisors should indicate their approval on the journal entry.

General Accounting Office (now the Government Accountability Office) (GAO), *Standards for Internal Control in the Federal Government,* November 1999, states that control activities include diverse activities such as approvals, authorizations, verifications, reconciliations, and performance reviews. The concept of approvals is more specifically addressed in an example from the University of Virginia’s accounting procedures manual. These procedures require that there be a separation of responsibility between individuals making non-routine journal entries (as opposed to routine journal entries, which might consist of the daily activity of processing accounts receivable and accounts payable). Specifically, entries that are not normally made on a daily basis as part of the routine accounting process should be forwarded to another individual who is responsible for approving and entering the journal entry, and ensuring compliance with GAAP and internal policies. Another individual should ensure that the general ledger is complete and all supporting documentation is maintained. Additionally, there should be an approver of the journal entry who ensures the journal entry is correct. Incorrect journal entries should be rejected and returned to the preparer with concise notes on what is wrong with the journal entry and the journal entry process should be repeated. Finally, a third party should review the journal entries prior to posting the ledger accounts.

The Financial Accounting Standards Board, in Statement of Financial Accounting Concept number six, explains the matching principle. According to the *Wiley GAAP Interpretation and Application of Generally Accepted Accounting Principles,* matching is the simultaneous recognition of the revenues and expenses that result directly and jointly from the same transaction or other event, and accurate financial reporting requires revenues and expenses to be matched by being reflected in the period they were earned or incurred, respectively. Accordingly, adjusting journal entries are required to be made at the end of the accounting period for the income statement to properly reflect bad debt and depreciation expenses.

According to GAAP, bad debt expense should be based on a review of historical data of bad debts or sales to determine the collectability of accounts receivable.

The correct method for accounting for fixed assets is to recognize an asset is less useful each year by the percentage of its useful life which has been diminished. For example, for an asset with a five-year life, one-fifth of the asset's value could be taken as an expense for each year. This annual decrease in value of the fixed asset is known as depreciation expense. A corresponding entry is made to decrease the value of the fixed asset into an account called accumulated depreciation.

<u>Results</u>

SBV did not properly account for revenue, depreciation expense, or bad debt expense for the simulators, as can be seen by comparing Table 1 with Table 2. Table 1 represents the revenues and expenses reported in SBV's accounting system.

Table 1
SBV Reported Amounts

Fiscal Year	Revenue	Expense	Net Income
2002	**$236,979**	**$183,018**	**$53,961**
2003	**181,459**	**-158,290**	**339,749**
2004 to date	**128,151**	**-7,636**	**135,787**
Totals	**$546,589**	**$17,092**	**$529,497**

Table 2 was produced by our office to more accurately reflect the results of the simulators' operation by identifying and correcting some of the larger erroneous accounting entries.

Table 2
Office of the Inspector General Computed Amounts

Fiscal Year	Revenue	Expense	Net Income
2002	$221,424	$49,885	$171,539
2003	347,245	55,528	291,717
2004 to date	169,118	42,775	126,343
Totals	$737,787	$148,188	$589,599

Examples of accounting errors observed are listed below.

Revenue

SBV understated simulator gross revenue by $191,198 for the period from April 1, 2002, to June 30, 2004. Most of this understatement occurred in fiscal year 2003 when SBV used a combination of estimated and actual amounts instead of recording actual revenues. SBV also recorded non-revenue transactions, such as depreciation and bad debt expense, in the revenue account. There were also numerous adjustments and corrections recorded into the revenue account.

Bad Debt Expense

SBV reported bad debt expense of $136,979 for the fiscal year ended 2002. The contractor had not made any payments to SBV from April 2002 to November 2002. According to GAAP, bad debt expense is calculated based on a review of historical data of bad debts or sales to determine the collectability of accounts receivable. When SBV's provision for bad debt expense was examined, no basis for the entry could be found. SBV management told us that they did not know how the entry was derived, but the result was a net receivables balance of $100,000.

Depreciation Expense/Accumulated Depreciation

We attempted to validate the expenses related to this project recorded in SBV's Lawson system. We found that SBV had not recorded either depreciation expense or accumulated depreciation according to GAAP. Instead, we found that entries were made without an understanding of the relevant accounting theory or the overall impact of the entries on the financial statement account balances. Using the GAAP-prescribed method would have resulted in depreciation expense of $120,987 for the period from April 1, 2002 to June 30, 2004. Instead, SBV had recorded entries into this account the cumulative effect of which was a negative depreciation balance of $10,082 in June 2004, a difference of $131,069. We also found that SBV had recorded incorrect amounts into the accumulated depreciation account. As of June 30, 2004, SBV's balance of accumulated depreciation was $201,643, an overstatement of $80,656 ($201,643-$120,987). Since the amount of accumulated depreciation equals the amount of fixed assets, management may make the false assumption that fixed assets are fully depreciated.

These conditions occurred because SBV lacked adequate training for its accounting staff, written accounting policies and procedures, and supervisory reviews of accounting entries. SBV was not reviewing accounting entries to make sure that ending account balances were properly stated. SBV management told us that review of these accounting entries was not a priority due to the small dollar amount of revenue from the simulators relative to more significant SBV activities such as the stores and theatres. We do not believe that the amount of revenue from the simulators should determine whether accounting entries are reviewed. Effective management of accounting procedures requires review of accounting entries, regardless of the size of the business operation.

The purpose of accounting information is to provide management with a basis for business decisions. Inaccurate accounting information makes sound management decisions more difficult. Although the amounts involved are small in relation to other business activities, this business is particularly important to the Institution because funds from its operations are being used to repay funds advanced to construct the Steven F. Udvar-Hazy Center. And while this business operation may have been small compared to other SBV operations, the amounts were not insignificant. For example, SBV recorded a depreciation expense into the simulator revenue for $161,315. This error could have been detected by supervisory review.

<u>Conclusion</u>

SBV should strengthen controls over the accounting for the simulators by improving its training, written procedures, and supervision. SBV should strengthen the review of reconciliations and end-of period adjustments. SBV should ensure accounting entries recorded in the Lawson system are reviewed and approved in accordance with GAAP. In particular, procedures are needed for recording estimates of expenses such as bad debt expense and depreciation expense, and for recording periodic and year-end adjustments.

<u>Recommendations</u>

We recommended that the Chief Financial Officer of Smithsonian Business Ventures:

1. Develop and implement written policies and procedures to record and review accounting entries in accordance with generally accepted accounting principles.

2. Institute accounting training for personnel entering accounting entries into the Lawson system.

<u>Management Comments</u>

1. Concur. Smithsonian Business Ventures will develop and implement written policies and procedures to record and review accounting entries in accordance with generally accepted accounting principles by September 30, 2005.

2. Concur. Smithsonian Business Ventures will reorganize its accounting function to address what it believes is primarily a “skill gap” issue by June 30, 2005.

C. <u>Utilities Expenses</u>

The utility bills for the simulators were not accurately calculated and were not promptly collected by the Office of Facilities Engineering and Operations (OFEO). SBV had not clearly communicated the terms and conditions of the simulator contract to OFEO until fiscal year 2004. Therefore, OFEO billed the contractor for heating, cooling, and electricity when they should have been billed solely for electricity. According to OFEO's records, for the period from April 2002 to June 2004, the contractor should have been billed $4,702 instead of $25,772. OFEO therefore over-billed the contractor by $21,070. From our discussions with SBV and OFEO, it became apparent that this issue requires coordination and cooperation between these units on a scale beyond the scope of this audit. OFEO followed up during our audit to correct its billing of utilities.

<u>Background</u>

The simulator was installed in gallery 103 in the west wing of the National Air and Space Museum by April 2002. SBV and the contractor agreed that electricity was the only utility cost the contractor would pay and an electricity meter was installed in that gallery. However, later that year, OFEO began billing the contractor for heating, cooling, and electricity. The contractor's management told us they did not pay the bill because they did not understand why it included the costs for heating and cooling, contrary to the terms of the contract.

Smithsonian Directive 115, *Management Controls*, states that "Transactions should be promptly recorded, properly classified, and accounted for in order to prepare timely accounts and reliable financial and other reports."

According to the contract between the simulator contactor and the Institution, "…the cost of electricity and any other utility cost required for the efficient performance of this agreement...will be paid by the contractor …." (pg. 20)

According to the Memorandum of Agreement executed in 2004 between SBV and the Institution on utilities charged for the SBV business activities:

(1) SBV agrees to notify the Office of Facilities Engineering and Operations when a new contract or business venture will be operating within Institution confines or leaving the Institution.

(2) SBV agrees to reimburse the Institution for the energy consumed by vendors, contractors or concessions operating under SBV control within or on Institution property.

(3) Failure by a contractor to pay for utilities consumed becomes a liability of SBV. SBV shall reimburse the Institution for any unpaid balances by contractors operating concessions at the end of each fiscal year.

The Smithsonian Institution "Inter-Unit Purchasing Requisition" form (also known as "Form M") requires inter-unit receivables to be submitted to the Office of the Comptroller (OC) so they may be recorded in the same fiscal period in which the receivables transaction occurred. To receive payment, SBV is required to sign the Form M and forward it to OC for processing.

Results

The utility bills for the simulator were not accurately billed and were not promptly collected by OFEO for a number of reasons: SBV had not clearly communicated the terms and conditions of the simulator contract to OFEO until fiscal year 2004; the Memorandum of Agreement did not include controls to ensure accurate calculation of utilities billed to contractors and did not include controls for following up on unpaid bills; OFEO did not notify SBV that the contractor had not paid OFEO; and SBV did not have procedures to reimburse OFEO for simulator utility expenses via the Form M. During our discussions with OFEO and SBV, both agreed that the Memorandum of Agreement that governs their relationship for billing SBV contractors needed to be refined.

As a result, the contractor did not pay OFEO's bills at first because the bills apparently did not comply with the contract terms. SBV also did not record the unpaid utility expenses as a liability in SBV accounting records because SBV was not aware of the amount that OFEO had billed the contractor or that the contractor had not paid OFEO. SBV was therefore not aware that it needed to reimburse OFEO for the unpaid contactor's utility bill.

On September 20, 2004, the contractor paid OFEO $3,511 towards the total electricity bill of $4,702. The payment covered fiscal years 2003 and 2004, excluding the fourth quarter of 2004. The remaining unpaid balance is $1,191, which covers the third and fourth quarters of fiscal year 2002. OFEO informed us that they will re-bill the contractor for the correct amount for fiscal year 2002. The contractor was billed for the fourth quarter of fiscal year 2004. According to the Memorandum of Agreement, SBV is responsible for paying for the contractor's heating and cooling costs. Because OFEO and SBV had not established which unit would pay for heating and cooling prior to the finalized Memorandum of Agreement in 2004, it was unclear which unit would bear those costs. Therefore SBV and OFEO have to determine which unit is responsible for paying the $21,069 for the heating and cooling costs for fiscal year 2002 through the first three quarters of 2004.

Conclusion

Improvements are needed in internal controls over the billing and collection of utility services to ensure that the contractor is correctly billed and that OFEO receives payment promptly. The communication between SBV and OFEO on the contract terms and conditions needs to be improved. The Memorandum of Agreement should address how SBV will make payment to OFEO in the event the contractor does not pay SBV. OFEO and SBV should decide which organization will pay for the heating and cooling costs incurred prior to the effective date of the Memorandum of Agreement.

Recommendation

We recommended that the Chief Financial Officer of Smithsonian Business Ventures, in coordination with the Director of OFEO, refine responsibilities for payment of utilities expenses in the Memorandum of Agreement between Smithsonian Business Ventures and the Office of Facilities Engineering and Operations.

Management Comments

Concur. Smithsonian Business Ventures will initiate discussions with the Director, Office of Facilities Engineering and Operations by May 1, 2005.

D. Special Event Revenues

SBV did not maintain adequate controls to account for and follow up on special event revenues due from the National Air and Space Museum. SBV did not record the receivables related to these revenues accurately and promptly. SBV also did not properly evaluate whether the full amount of these receivables would be collectible and did not follow up closely enough with NASM to collect the receivables due from NASM. SBV lacked written procedures, did not follow generally accepted accounting principles, and did not have clearly defined responsibility for receivable collection. SBV had not received $63,000 in special event revenue from the museum from the inception of the simulator operation in April 2002 to our audit cutoff of June 30, 2004.

Background

The museum conducts special events at the museum, often after hours. The museum periodically requests the simulator contractor to make the simulator rides available for these special events. The museum and SBV have agreed that SBV will charge the museum $3,000 per special event for the use of the simulators. SBV should have recovered the funds for these events promptly from the museum using an "Inter-Unit Purchasing Requisition" form. The practice has been for the museum to contact both the simulator contractor and SBV to request the simulators for a special event. The simulator contractor then recorded the revenue from the special events on its monthly financial report to SBV. However, because the contractor does not receive payment from the museum, the contractor did not include the revenues from special events in its monthly remittance to SBV.

Smithsonian Directive 115, *Management Controls*, states that "Transactions should be promptly recorded, properly classified, and accounted for in order to prepare timely accounts and reliable financial and other reports."

The Smithsonian Institution "Inter-Unit Purchasing Requisition" form (Form M) requires inter-unit receivables to be submitted to the Office of the Comptroller (OC) so they may be recorded in the same fiscal period in which the receivables transaction occurred. To receive payment, SBV is required to sign the Form M and forward it to OC for processing.

Results

SBV did not maintain adequate controls to account for and follow up on special event revenues due from the museum. SBV personnel did not record these receivables accurately and promptly. For example, they under-recorded receivables by $15,000 in fiscal year 2002 and $6,000 in fiscal year 2003.

SBV did not follow up closely with the museum to collect the receivables because it had not clearly assigned one person responsibility for follow-up. Instead, SBV followed up on the receivable by completing the Form M used to transfer the funds from the museum to SBV annually rather than monthly.

SBV had not received $63,000 in special event revenue from the museum from the inception of the simulator operation in April 2002 until our audit cutoff of June 30, 2004.

SBV did not record receivables from the museum for the amount of special event revenue for fiscal year 2002 or 2003 until September 2003 and had not recorded a receivable for fiscal year 2004 as of October 8, 2004. By not recording receivables for the special event revenue due from the museum, SBV understated its assets and revenues from the operation of the simulator by $15,000 for fiscal year 2002 and $6,000 for fiscal year 2003. Net revenues from the simulator are needed to repay funds advanced to the museum to construct the Steven F. Udvar-Hazy Center. Museum management also told us that it was more difficult for them to manage their budget because of the funds due SBV.

Conclusion

SBV could strengthen controls over the collection of special event revenue from the museum by assigning responsibility for follow up and by improving procedures. During our audit, we noticed that SBV had begun to follow up with the museum to collect the revenues.

Recommendation

We recommended that the Chief Financial Officer of Smithsonian Business Ventures develop and implement written procedures for SBV to accurately and promptly record receivables and follow up on intra-institutional receivables.

Management Comments

Concur. Smithsonian Business Ventures will develop and implement written procedures for accurately and promptly recording receivables and follow up on intra-institutional receivables by June 1, 2005.

Appendix A. Management Comments

Smithsonian Business Ventures

February 23, 2005

Gerard Roy
Acting Inspector General
Smithsonian Institution
Victor Building Suite 4200
750 Ninth Street, NW
Washington, DC 20560-0905

Re: SBV Response to the Final Draft Report on Audit of the National Air and Space Museum Mall Simulators, dated February 4, 2005

Dear Mr. Roy:

Recommendation A – Contractor Selection Procedures
SBV concurs with the recommendation and recognizes the need to develop and implement appropriate written contractor selection procedures. SBV will develop and implement these procedures by March 1, 2006.

It should be noted however that SBV management has identified areas of the audit findings (previously discussed with IG) that do not adequately explain or represent SBV management's view.

1)SBV has historically not maintained a legal or contracting staff but has relied on the support of OGC and OCON for legal and contract work. With regard to the development of RFP's and related contracts, SBV works closely with both groups and adheres to the guidance which they provide.

2)Neither SBV or SI had experience operating simulator attractions at the time the Simulator deal was being considered. When the RFP was being developed and considering that there was a very limited pool of potential contractors, OGC deemed, and SBV agreed, it unfair to potentially consult with one simulator company to define the Institution's needs. Instead, SBV and OGC constructed the RFP so that the respondents would provide their best proposal for a simulator attraction at NASM, yielding "expert" input from those vendors for SSBV to utilize in the selection process.

3)SBV management views the conclusion that the "lack of written contractor selection procedures caused the financial and operational weaknesses" as speculative. SBV agrees that greater analysis could have been applied to the review of the vendor's financial health, however to assume that SBV could have predicted the negative financial impacts on the vendor as a result of September 11th and a loss of primary financing is unreasonable. In light of the fact that there were limited vendor alternatives at the time, SBV management moved forward with a deal that mitigated financial risk to the

SMITHSONIAN INSTITUTION
Victor Building
MRC 951 P.O. Box 37012
Washington DC 20013-7012
202.275.1231 Telephone
202.275.1972 Fax

Institution and when the vendor's financial issues became evident, restructured the deal to further mitigate that risk.

Recommendation B.1 – Accounting and Reporting Procedures: Policies and Procedures
SBV concurs with the recommendation to develop and implement written polices and procedures to record and review accounting entries in accordance with generally accepted accounting principles.
Prior to this audit SBV had already identified the need to reorganize and centralize currently decentralized financial and accounting functions. SBV had also, already embarked on an SBV-wide review of accounting polices and procedures. KPMG was retained to complete Phase 1 of the project, which was to document existing basic accounting procedures at SBV's business units. This has been completed. As part of the reorganization these procedures will be reviewed and revised where appropriate, consistent with the objective of the IG's recommendation. SBV will complete this review by September 30, 2005.

Recommendation B.2 – Accounting and Reporting Procedures: Training
SBV agrees that training in an important component of its accounting operations and concurs with the intent of the recommendation. While ongoing training is of value, SBV's CFO has already identified this as primarily a "skill gap" issue and is taking steps as part of a planned reorganization to enhance SBV's overall accounting capabilities.

Recommendation C – Utility Expenses
Response – SBV concurs with the recommendation. Although not able to unilaterally modify the Memorandum of Agreement between SBV and OFEO, the CFO, SBV will initiate discussions with the Director, OFEO, before May 1, 2005.

Recommendation D – Special Events Revenues
Response – SBV concurs with the recommendation. The CFO, SBV will document procedures for recording intra-institutional accounts receivables and following up on delinquent reimbursements. This project will be completed prior to June 1, 2005.

Sincerely,

Marc Saitta
Chief Financial Officer
Smithsonian Business Ventures

The following Office of the Inspector General personnel participated in this audit: Brian Lowe, Supervisory Auditor, Douglas Kodish, Auditor, and Joyce Smith, Auditor.