



Smithsonian
Institution

The Center for Folklife and Cultural Heritage Needs to Improve Its Financial Management Operations

Office of the Inspector General

**Accounting Information Systems
at the Center for Folklife and
Cultural Heritage, Report Number
A-11-09**

September 28, 2012



In Brief

The Center for Folklife and Cultural Heritage Needs to Improve Its Financial Management Operations, A-11-09, September 28, 2012

Why We Did This Audit

We conducted this audit to assess whether the accounting information systems (1) reconcile to the Smithsonian's Enterprise Resource Planning system, (2) provide management an accurate view of Center for Folklife and Cultural Heritage's (CFCH) business activities, and (3) can be improved to increase efficiencies.

Background

CFCH is a research and educational unit of the Smithsonian Institution dedicated to promoting the understanding and continuity of diverse, contemporary grassroots cultures in the United States and around the world. CFCH's primary activities are the Smithsonian Folklife Festival (Festival) and Smithsonian Folkways Recordings (Folkways). The Festival is an annual event held outdoors on the National Mall. Folkways has a collection of over 43,000 recordings that are available for purchase. To manage these activities, CFCH utilizes various accounting information systems for its operations.

What We Found

We found that the Center for Folklife and Cultural Heritage (CFCH) needs to increase oversight of the accounting information system that Smithsonian Folkways Recordings (Folkways) uses to capture sales, inventory, accounts receivable data, and other financial information. We also determined that CFCH needs to improve management of the Festival Marketplace point of sale system, which is used to manage Festival Marketplace operations. In addition, we found that CFCH needs to improve segregation of duties and cross-train staff to perform key financial tasks.

CFCH's ability to make sound business decisions is impaired because the inventory and accounts receivable records are inaccurate. In addition, because information from these subsidiary ledgers is transferred to the Enterprise Resource Planning (ERP) system, the Smithsonian's official accounting records, specifically inventory and accounts receivable, are also inaccurate.

What We Recommended

We made eight recommendations intended to ensure that Folkways' accounting records reconcile to ERP and to provide management an accurate view of its profitability.

We made four recommendations directed at improving internal controls over Festival Marketplace activities.

Lastly, we made five recommendations to improve management over financial activities, as well as to strengthen CFCH's user access controls over systems that accept payment cards.

Management concurred with our findings and recommendations and has proposed or taken corrective actions that will address the recommendations. Based on corrective actions taken by management, we closed five recommendations as of the date of this report.

For additional information or a copy of the full report, contact the Office of the Inspector General at (202) 633-7050 or visit <http://www.si.edu/oig>.



Office of the Inspector General

Date September 28, 2012

To Daniel Sheehy, Director, Center for Folklife and Cultural Heritage
Andrew Zino, Comptroller
Deron Burba, Chief Information Officer

cc Albert Horvath, Under Secretary for Finance and Administration/
Chief Financial Officer
Richard Kurin, Under Secretary for History, Art, and Culture
Patricia Bartlett, Chief of Staff, Office of the Secretary
Judith Leonard, General Counsel
John Clark, Budget Analyst, Office of Planning, Management and
Budget
Stone Kelly, Program and Budget Analyst, Office of Planning,
Management and Budget

From Scott S. Dahl, Inspector General

A handwritten signature in black ink, appearing to read "Scott S. Dahl".

Subject The Center for Folklife and Cultural Heritage Needs to Improve Its Financial
Management Operations, A-11-09

Attached please find a copy of our final report titled *The Center for Folklife and Cultural Heritage Needs to Improve Its Financial Management Operations*.

We made eight recommendations to ensure that the Smithsonian Folkways Recordings' accounting records reconcile to the Enterprise Resource Planning system and to provide management an accurate view of its profitability. We made four recommendations directed at improving internal controls over Festival Marketplace activities. Lastly, we made five recommendations to improve management over financial activities, as well as to strengthen the Center for Folklife and Cultural Heritage's user access controls over systems that accept payment cards. Management concurred with our findings and recommendations and has proposed or taken corrective actions that will address the recommendations.

We appreciate the courtesy and cooperation of the staff of the Center for Folklife and Cultural Heritage and the Office of the Comptroller during this audit.

Please call Michael Sinko, Assistant Inspector General for Audits, or Joan Mockeridge, Supervisory Auditor, on 202.633.7050 if you have any questions.

INTRODUCTION

This report presents the results of our audit of accounting information systems at the Center for Folklife and Cultural Heritage (CFCH). Our objectives were to assess whether the accounting information systems (1) reconcile to the Smithsonian's Enterprise Resource Planning (ERP) System, (2) provide management an accurate view of CFCH's business activities, and (3) can be improved to increase efficiencies. We describe in detail our audit scope and methodology in Appendix A.

CFCH's primary activities are the Smithsonian Folklife Festival (Festival) and Smithsonian Folkways Recordings (Folkways). The Festival is an annual event held outdoors on the National Mall. Folkways manages a collection of over 43,000 recordings that are available for purchase. To manage these activities, CFCH utilizes various accounting information systems for its Festival and Folkways operations. This audit focused on the following systems:

- *Participant Tracking System* – tracks Festival participants' travel, honorarium, and miscellaneous expenses.
- *Marketplace Point-of-Sale System (POS)* – tracks inventories, assigns bar codes, tracks sales, and creates vendor invoices at the annual Festival.
- *NetSuite* – financial system Folkways uses to manage its record label.
- *Record Maestro* – contains royalty payment information.

RESULTS IN BRIEF

We found that the Center for Folklife and Cultural Heritage (CFCH) needs to increase oversight of the accounting information system that Smithsonian Folkways Recordings (Folkways) uses to capture sales, inventory, accounts receivable data, and other financial information. Specifically we found that:

- CFCH was not effectively maintaining subsidiary records for Folkways.
- Folkways' inventory management and accounts receivable, does not reconcile to ERP. For example, we identified a variance of approximately \$349,000 between Folkways' and the Smithsonian's ERP inventory records.
- Neither Folkways nor the Office of the Comptroller (OC) could resolve a difference of \$127,000 between Folkways' accounts receivable records and ERP.

CFCH's ability to make sound business decisions is impaired because the inventory and accounts receivable records are inaccurate. In addition, because information from these subsidiary ledgers is transferred to ERP, the Smithsonian's official accounting records, specifically inventory and accounts receivable, are also inaccurate.

We also determined that CFCH needs to improve management of the Festival Marketplace POS system, which is used to manage Marketplace operations. For example:

- CFCH needs to increase oversight of the Festival's POS system, as it relates to vendor payments, recording of inventory, and daily deposit of Marketplace cash proceeds.
- CFCH was not following Smithsonian password policies to access the POS system.

Lastly, we found that CFCH needs to improve segregation of duties and cross-train staff to perform key financial tasks.

We made eight recommendations intended to ensure that Folkways' accounting records reconcile to ERP and to provide management an accurate view of its profitability. Implementing these recommendations will improve the accuracy and management of inventory and accounts receivable records.

We made four recommendations directed at improving internal controls over Festival Marketplace activities. Once implemented, these recommendations will help ensure improved controls over the Marketplace inventory and daily cash deposits.

Lastly, we made five recommendations to improve management over financial activities, as well as to strengthen CFCH's user access controls over systems that accept payment cards.

Management concurred with our findings and recommendations and has proposed or taken corrective actions that will address the recommendations. Based on corrective actions already taken by management, we closed five recommendations as of the date of this report. Please refer to Appendix B for management's complete response. Please refer to Appendix C for a Schedule of Recommendation Completion Dates.

BACKGROUND

CFCH is a research and educational unit of the Smithsonian Institution dedicated to promoting the understanding and continuity of diverse, contemporary grassroots cultures in the United States and around the world. CFCH's primary activities are the Festival and Smithsonian Folkways Recordings. CFCH produces exhibitions, documentary films and videos, symposia, publications, and educational materials. CFCH also conducts ethnographic and cultural heritage policy oriented research, maintains the Ralph Rinzler Folklife Archives and Collections, and provides educational and research opportunities through fellowships, internships, and training programs. CFCH's activities are funded by:

- federal appropriations;
- Smithsonian trust funds;
- contracts and agreements with national, state, and local governments;
- foundation grants;
- gifts from individuals and corporations;
- income from the Festival; and
- Folkways product sales.

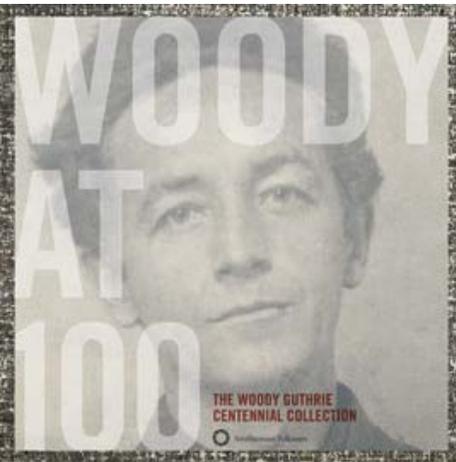
The Smithsonian Folklife Festival

The Festival is an annual event held outdoors on the National Mall. CFCH has been producing the festival since 1967. CFCH invites musicians, artists, performers, craftspeople, workers, cooks, storytellers, and others to the National Mall to display their talents in a venue that is free to the public. Each year, Festival organizers diversify the programs by featuring a nation, region, and state or theme. Since its inception, the Festival has featured programs from more than 90 countries. The Festival supports funding for CFCH through various profit generating activities such as Marketplace sales of vendor crafts and food concessions that are related to the particular year's programs. In 2011, the Festival grossed approximately \$590,000 in revenue from Marketplace and concession sales. After paying Festival related expenses, such as cost of goods sold and salaries, the Festival netted approximately \$137,000. These funds are used to support CFCH's department and programs.



The Smithsonian Folklife Festival is an annual two week event on the National Mall.

The Smithsonian Folkways Recordings



In 2012, Folkways Recordings will release *Woody at 100: The Woody Guthrie Centennial Collection*, a commemorative collection of his work.

In 1987, the Smithsonian acquired the Folkways Records & Service Company, which was founded in 1948 by Moses Asch, to ensure that the collection of approximately 2,200 folk albums would be available to future generations. The collection includes traditional, ethnic, and contemporary music from around the world; poetry, spoken word, and instructional recordings in numerous languages; and documentary recordings of individuals, communities, current events, and natural sounds. This collection has grown to include over 43,000 individual recordings that are sold primarily as compact discs or digital downloads. Folkways distributes music through its website, mail order catalogue, and third parties such as iTunes and eMusic. In

2011, Folkways generated approximately \$3,600,000 in gross revenue.

In 2009, CFCH signed a Memorandum of Understanding (MOU) to share half of Folkways' first \$200,000 of annual net gains or losses with the Central Trust Fund. The Central Trust Fund received approximately \$100,000 in fiscal year 2011 and \$57,000 in fiscal year 2010.

CFCH Accounting Information Systems

CFCH uses the following four accounting information systems to manage its financial operations. CFCH and OC staff manually enter some financial information from these subsidiary systems into the ERP Financials system, the Smithsonian's official accounting records.

Folklife Festival Accounting Information Systems

Participant Tracking System – Folklife Festival staff (Folklife) use this Access-based system to track Festival participants. Folklife staff also use the system to generate purchase orders and payment vouchers for the Festival participants' travel, honorarium, and miscellaneous expenses.

Marketplace Point-of-Sale System (POS) – Festival Marketplace staff use the POS system to record inventories, assign bar codes, track sales, and create vendor invoices at the annual Festival. The vendor invoices are used to pay merchants whose products are sold at the Festival Marketplace.

Folkways' Accounting Information Systems

NetSuite – Folkways staff use this web-based financial system to capture sales and inventory data for music merchandise and digital recordings sold through the Folkways website and the mail order catalogue. Staff also use NetSuite to record accounts receivable, royalty payments, and other financial data.

Record Maestro – Record Maestro is a royalty payment management system. Folkways staff use the Record Maestro system to calculate royalty payments owed to artist royaltors¹ and mechanical licensees.² Folkways staff enter the royaltors and licensees into the Record Maestro system based on their agreements. To make royalty payments, Folkways uploads sales data from NetSuite and third parties such as iTunes and eMusic. Based on the uploaded sales data, the Record Maestro system calculates the royalties owed to artist royaltors and mechanical licensees.

Smithsonian's Official Accounting Records

ERP – The ERP system contains financial management data used by the Smithsonian. Financial management consists of the following: asset and liability management, reporting, budget and finance, accounting, payments, and collections and receivables, in accordance with applicable federal standards.

¹ Artist royaltors are recording artists, compilers, producers, as well as companies that licensed master recordings to Folkways. Royalties are determined by contracts with Folkways.

² Mechanical licensees are music publishers or composers who own the copyrights in musical compositions embodied in sound recordings. Mechanical royalties are based on statutory rates set by Congress.

Financial Management Roles and Responsibilities

Folkways – Folkways staff are responsible for direct supervision of all aspects of Folkways' financial operations including inventory management, accounts receivable, and royalty payments. In addition, they have the primary responsibility to perform the monthly reconciliation of accounts receivable.

Folklife – Folklife staff are responsible for the planning and the management of the Festival. Specifically, they monitor the Festival concessionaires and administer the Marketplace. Folklife staff are authorized to make direct payments to Festival participants.

Office of the Comptroller (OC) – OC staff are responsible for maintaining the official books and accounts of the Smithsonian. In addition, it provides technical guidance of activity accounting to assure the validity of accounts and reports. OC's Financial Analysis and Reporting Division is responsible for verifying that the monthly accounts receivable reconciliation is performed by the appropriate party.

Office of the Chief Information Officer (OCIO) – OCIO staff are responsible for educating the Smithsonian community about data security responsibilities and assisting units with implementing data security standards, as they relate to accounting information systems. In addition, OCIO co-chairs the Payment Card Industry (PCI) Working Group to coordinate Smithsonian payment card compliance activities.

Smithsonian Policies and Procedures

Smithsonian Directive (SD) 301 *Financial Management Accounting Practices and Procedures* communicates the Smithsonian's accounting policies and procedures. The directive is supported by the *Financial Management Accounting Policies and Procedures Handbook* which includes the Smithsonian's accounts receivable and bookkeeping policies.

SD 313 *Smithsonian Auxiliary Activities Handbook* describes accounting policies and procedures such as inventory control and cash management for Smithsonian auxiliary activities.

SD 309 *Merchant Accounts, Payment Cards, and the Payment Card Industry Data Security Standard* outlines various responsibilities regarding PCI compliance for units that accept payment cards for products, services, or donations. This directive is supported by the *Payment Card Handbook* which outlines procedures that units must follow to accept payment card transactions.

SD 931 *Use of Computers, Telecommunications Devices and Networks* outlines policies for all users of Smithsonian computers, telecommunications devices, and networks, including all hardware connected to Smithsonian computers and networks.

SD 310 *Financial Reporting and Risk Management Internal Controls* outlines policies and procedures for establishing, documenting, assessing, and reporting on the financial management internal controls that are critical for safeguarding Smithsonian assets.

RESULTS OF AUDIT

In reviewing CFCH's accounting information systems, we found that CFCH was not effectively maintaining reliable subsidiary records for Folkways. In addition, we determined that CFCH could improve oversight of its Festival Marketplace activities, such as ensuring daily deposits of cash and that all vendor products are entered into the POS system prior to sale. We also determined that CFCH could improve segregation of duties and succession planning for its key financial personnel. Lastly, we determined that CFCH should strengthen user access controls over systems that accept payment cards.

The Folkways Profit and Loss Statement is Not Reliable

CFCH needs to improve oversight of the financial management of its Folkways' operations. During the course of our audit, we determined that neither Folkways' inventory nor its accounts receivable records were accurate. As a result, Folkways' profit and loss statement generated from ERP is not an accurate representation of Folkways' profitability. During the course of our audit, CFCH hired a firm that has accounting experience with independent record labels. This firm has been working with CFCH and OC to address the inventory and accounts receivable valuations.

Inventory

Folkways needs to improve management of its inventory records that are maintained in NetSuite, a web-based accounting information system. As of September 30, 2011, ERP reported inventory at approximately \$911,000, while NetSuite reported inventory at approximately \$562,000, a variance of \$349,000. We found specific instances where inventory balances differed between NetSuite and ERP. For example, as of September 30, 2011, ERP showed a negative balance of approximately \$400 for shirts, while NetSuite had a positive balance of approximately \$4,300. In addition, Folkways staff cannot support the unit costs in NetSuite, which are the costs incurred to produce one unit of a product. Therefore, Folkways' inventory values in ERP and NetSuite are not reliable.

According to staff job descriptions, Folkways senior management is responsible for direct supervision of all aspects of financial operations including inventory management. The *Financial Management Accounting Policies and Procedures Handbook*, referenced in SD 301, assigns OC the responsibility to maintain the official books and accounts of the Smithsonian, as well as to provide technical supervision of activity accounting to assure the validity of accounts and reports. The inventory inaccuracies are the result of several causes:

- Folkways accounts for finished products as separate components, such as compact discs (CD), printed material, and cases. However, Folkways is not accounting for all of the cost of goods sold expenses because it does not expense all of the products' components when it sells inventory. For example, it did not properly expense promotional materials.
- During the course of our audit, Folkways could not support the unit costs for a test sample of products selected by OC. Folkways was unable to support unit costs because it did not properly include freight in the calculation. The lack of electronic integration between the distributor's sale system and NetSuite also contributed to management's difficulty when calculating unit costs. The lack of integration required Folkways staff to manually enter sales data from the distributor into NetSuite. However, Folkways had not consistently entered the sales data into NetSuite. This affected the product counts used to calculate the average cost of a unit.³ During the course of our audit, Folkways took steps to integrate data from the distributor into NetSuite.
- Folkways produces a report that projects the number of years it will take to sell CDs on hand, based on historical sales data. However, it lacks a written policy that defines aging thresholds used to write-off inventory. Folkways management stated it would be reasonable to have up to ten years of CDs on hand, but its most recent report projects that it would take more than ten years, and in some cases up to fifty years, to sell many of its CDs.

Without reliable inventory records, the potential effect is that Folkways may misstate its profitability. Unreliable records increase the risk that Folkways will not have accurate financial information necessary to make sound business decisions. For example, unreliable profitability data has a potentially negative effect on Folkways' decisions regarding the number of new recordings to produce and staffing decisions.

In addition, OC generates Folkways' profit and loss statement from the data in ERP. CFCH transfers a share of its profits, as outlined in the 2009 MOU, based on Folkways' profit and loss statement. Because this data is unreliable, the amount transferred to the Central Trust Fund may not have been correct.

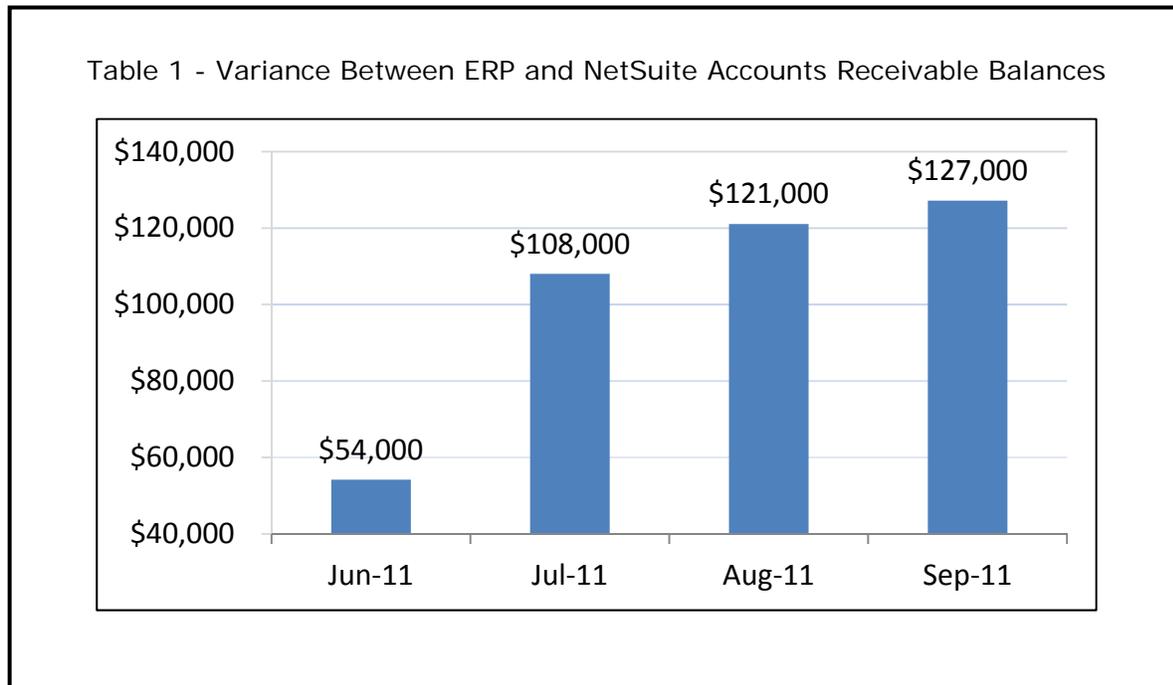
Smithsonian management informed us that they have suspended the MOU until they can determine that the data captured in Folkways' profit and loss statement is reliable.

Accounts Receivable

Folkways needs to improve management of accounts receivable for mail order sales to distributors and educational institutions. We found that Folkways' accounts

³ The average unit cost is obtained by dividing the total number of units produced by the production cost.

receivable does not reconcile to ERP. In June 2011, OC reported an unexplained accounts receivable variance of approximately \$54,000 between NetSuite and ERP accounting records. As of September 30, 2011, this variance had grown to approximately \$127,000. Neither Folkways nor OC have been able to resolve the difference. Based on our review of the accounting records, we determined that the balances in both the NetSuite subsidiary ledger and the ERP general ledger are inaccurate. See Table 1.



We also found that the NetSuite accounts receivable aging summary report included Folkways' customers with credit or uncollectible balances. According to the NetSuite report, as of January 2012, more than 30% of accounts receivable were 90 or more days past due. Because the information in NetSuite is unreliable, we could not confirm the accuracy of the aging summary report.

SD 301 *Financial Management Accounting Policies and Procedures Handbook* states that Smithsonian unit directors are responsible for the effective management of accounts receivable including reviewing outstanding accounts receivable balances for uncollectible accounts.

In addition, CFCH has the primary responsibility to perform the monthly reconciliation, or ensure the monthly reconciliation is performed in coordination with its OC liaison. OC's Financial Analysis and Reporting Division is responsible for verifying that the monthly accounts receivable reconciliation is performed by the appropriate party. The units are required to have written policies regarding how they extend credit and procedures to conduct timely and systematic follow-up collection efforts on unpaid accounts after 30 days.

The accounts receivable inaccuracies are the result of several factors:

- Folkways staff acknowledged that the NetSuite subsidiary ledger had not always been updated to reflect payments received. The unit's focus had been on providing accounts receivable payment information to OC to post to the official Smithsonian accounting records.
- Folkways staff submit cash receipts vouchers (CRV) to OC's Cash Management Office to record payments. According to OC, CRVs have been prepared incorrectly, resulting in the Cash Management Office posting payments to the wrong accounts, including accounts that were reportedly closed. In recent months, an OC liaison accountant has been able to identify and bring some of the incorrect entries to Folkways' attention.
- Folkways staff responsible for collecting payments may not have accurate information on delinquent accounts because accounts receivable data in the NetSuite subsidiary ledger is not reliable.
- Although Folkways has a policy covering accounts receivable collections in its Folkways Mail Order Manual, this policy does not include written instructions as to when Folkways should write-off uncollectible accounts. In addition, this policy has not been submitted to OC as required by Smithsonian policies.

Folkways provides documentation to OC to support the ERP accounts receivable balance. Because the NetSuite subsidiary ledger is inaccurate, information transferred to ERP is unreliable, and the potential effect is that ERP may misstate Folkways' profit and loss statement. As with its inventory records, Folkways may erroneously make business decisions based on unreliable financial information.

Recommendations

We made the following recommendations to ensure that Folkways' accounting records reconcile to ERP and to provide management an accurate view of its profitability.

To improve the accuracy of the inventory value and the ability of Folkways staff to accurately account for it, we recommend that the Comptroller:

1. Provide technical assistance to the Director of CFCH to determine the appropriate application of the average cost method used to value Folkways' inventory.

To improve oversight of the Folkways inventory, we recommend that the Director of CFCH:

2. Develop and implement policies and procedures for the selected application of the inventory method. These policies and procedures should include aging thresholds used to write-off inventory. Ensure that staff receive proper training regarding the inventory method selected.
3. Review and research current inventory documentation to identify actual account balances. If necessary, rebuild the accounts to accurately reflect assets.
4. Revise staff performance plans to include requirements to ensure accuracy of prepared financial information.

To improve oversight of the Folkways accounts receivable, we recommend that the Director of CFCH:

5. Review and research NetSuite accounts receivable to identify the actual account balances. If necessary, rebuild the accounts to accurately reflect assets.
6. Revise the Folkways Mail Order Manual to include policies that identify aging thresholds used to write-off accounts receivable. Submit the revised policy to OC, as required by the Smithsonian *Financial Management Accounting Policies and Procedures Handbook*.
7. Direct Folkways staff to meet with OC personnel to improve the process for accurately preparing CRVs and other unit generated journal entries.

To ensure that appropriate amounts are being transferred to the Central Trust Fund from Folkways, we recommend that the Under Secretary for History, Art, and Culture and the Under Secretary for Finance and Administration:

8. Suspend the Memorandum of Understanding, *Treatment of Folkways Fund 420 Unit Business Activity Year-End Assets* until Folkways' accounting records accurately reflect Folkways' profitability as defined by the Comptroller.

Management has concurred with recommendations 1 through 8 and has planned or taken corrective actions to address the recommendations. Further, management provided support for completion of recommendations 7 and 8. For recommendation 7, we verified that CFCH management and OC personnel have addressed the accurate preparation of CRVs and other journal entries. For recommendation 8, we confirmed that management has suspended the Memorandum of Understanding until Folkways accounting records accurately reflect financial profitability. We believe that these actions meet the intent of recommendations 7 and 8. We will close these recommendations effective the date of this report.

Financial Management of the Festival Marketplace POS System Needs Improvement

Folklife needs to improve management and oversight of the Festival's POS system. Folklife enters into agreements with vendors to provide products for the annual Festival. Folklife records inventories, tracks sales, and creates vendor payable invoices in the POS system. In 2011, Folklife paid approximately \$225,000 to Marketplace vendors for products on gross sales of approximately \$418,000. Folklife management reported that this payment included approximately \$7,000 for goods they determined to be lost or stolen.

We also found that when Folklife sold products to Smithsonian staff after the Festival, there were poor controls over recording and receipt of proceeds. For example, not all sales transactions were processed through the POS system and Folklife staff could not account for some cash receipts.

According to Folklife management, to address these problems, they conducted the 2012 staff sale immediately following the Festival on the Mall grounds rather than up to a month later. Folklife management made this change to ensure that proper controls remained in place and the POS system remained operational for the recording of those sales.

SD 310 states that management should establish control activities that are effective and efficient. In addition, Folklife practices require staff at the Festival to load inventory into the POS system prior to sale.

Poor controls over the financial management of the Festival Marketplace activities were the result of the following:

- Folklife does not have written policies and procedures to record inventory in the POS system prior to sale. As a result, vendor invoices produced from the POS system did not accurately reflect items received. We determined that these vendor payments were based on inaccurate invoices. In addition, Folklife did not have written procedures to close out vendor accounts at the end of the Festival. Folklife staff also attributed incorrect vendor invoices to a lack of training and high turnover of temporary Festival staff.
- Folklife management had poor oversight of post-Festival staff sales made in August and September of 2011. During the audit, Folklife staff determined that approximately \$240 of sales to Smithsonian staff were not recorded in the POS system. In addition, approximately \$430 was recorded in the POS system, but was not supported by a cash receipt or input in ERP.

Because of these internal control deficiencies, Folklife may not be maximizing the financial performance of the Festival Marketplace. As a result of invoice records not accurately reflecting products received, Folklife is unable to determine whether it is reimbursing vendors for products that were lost or stolen, or paying for products that it never received. In addition, Folklife's lack of oversight of post-Festival sales increases the risk that some sales will be improperly recorded or omitted.

Recommendations

To strengthen controls over the Festival POS system, we recommend that the Director of CFCH:

9. Formalize and implement procedures to document incoming inventory and ensure that all products are entered in the POS system prior to sale.
10. Formalize and implement inventory close-out procedures for vendor accounts.

Management has concurred with recommendations 9 and 10 and has planned or taken corrective actions to address the recommendations. For recommendation 9, CFCH management developed new procedures for documenting incoming Festival inventory. Based on this documentation, as well as the results of OC's compliance review of the 2012 Festival Marketplace operations, it appears that CFCH did not fully implement these procedures. Therefore, this recommendation will remain open until CFCH management fully implements the procedures.

Folklife did not Make Timely Cash Deposits of Sales from the Festival Marketplace

During our review of the Festival Marketplace activities, we identified several occurrences where Folklife staff did not make daily deposits of cash and checks received from sales activity. In fact, Folklife staff waited up to 12 days to deposit approximately \$30,000, or 39 percent of total Marketplace cash and check sales.

SD 313 states that management should deposit cash daily to reduce the risk of loss through theft or carelessness. However, Folklife staff stated that competing priorities during the Festival prevented them from making daily deposits from Marketplace activities. Therefore, they kept the deposits in a safe. Based on the results of our audit, for the 2012 Festival, Folklife management stated that daily cash and check deposits were made.

Both OC and Folklife developed *Smithsonian Cash Handling Guidelines for Concessionaires and Marketplace Operations*, which requires the Marketplace Cash Manager to prepare daily deposit bags, but does not require daily deposits. However, OC updated the *Smithsonian Guidelines for Concessionaires and Marketplace Operations* to include the requirement for daily cash deposits and provided us a copy.

Recommendations

To be consistent with SD 313, we recommend that the Comptroller:

11. Revise *Smithsonian Cash Handling Guidelines for Concessionaires and Marketplace Operations* to include a requirement for daily cash deposits.

To mitigate the risk of loss of daily cash receipts, we recommend that the Director of CFCH:

12. Ensure that Festival staff make daily deposits in accordance with the revised guidelines.

Management concurred with recommendations 11 and 12. For recommendation 11, OC has revised the *Smithsonian Cash Handling Guidelines for Concessionaires and Marketplace Operations* to include a requirement for daily cash deposits. For recommendation 12, CFCH management provided evidence of daily deposits during the 2012 Festival. We believe that these actions meet the intent of our recommendations and we will close them effective the date of this report.

CFCH Needs to Improve Management Over Financial Activities

CFCH's key financial management staff are responsible for the majority of the financial activities, often with little supervisory review. This lack of supervision has led to poor segregation of duties with regards to file maintenance and cash disbursement, preparation and review of journal entry, and records management. SD 310 states that unit directors are responsible for delegating authority that is consistent with standards for proper segregation of responsibilities.

We also determined that CFCH has not identified and trained alternate staff for key financial activities when assigned staff are not present. For example, we learned of an incident where a financial manager was on leave for several weeks and key financial functions were not performed. Specifically, Folkways was unable to reconcile mail order sales processed through a third party vendor. The Office of Personnel Management has recommended cross-training as an opportunity to prepare employees to perform key financial functions in the event of staff shortages.

Inadequate segregation of duties and lack of cross-training were the result of several factors:

- CFCH have limited staff assigned to financial operations. To compensate for limited staff, CFCH has assigned key management staff incompatible duties. For example, the Folklife financial manager has the ability to modify Festival payment information and is the only person authorized to disburse payments. In addition, the Folkways financial manager generates and approves CRVs with no oversight.

- According to CFCH staff, management has provided limited opportunities to cross train the Folklife and Folkways staff. CFCH has limited written policies and procedures that would allow for work to continue when key financial managers are absent. For example, Folkways has assigned only one staff member to manage Record Maestro. This person is responsible for overseeing the input of royalty and licensing data into the royalty payment system; calculating royalty payments for artists and mechanical licensees; pursuing licenses for tracks on Folkways' recordings; and researching artists that are due royalty payments.

We believe that the proper segregation of duties will help ensure the timely detection of errors. In addition, the risk of lack of continuity of business increases when employees are not cross-trained to perform key business operations.

Recommendations

To ensure the continuity of operations and appropriate segregation of duties, we recommend that the Director of CFCH:

13. Develop and implement additional written policies and procedures for key financial activities.
14. Develop cross-training plans to address potential staff turnover and absence. This plan should include opportunities to cross-train staff to mitigate risks caused by resource constraints.

Management has concurred with recommendations 13 and 14 and has planned corrective actions to address the recommendations.

CFCH is not Following Password and Payment Card Policies

During our review of CFCH's accounting information systems, we determined that CFCH was not following Smithsonian policies as outlined in SD 309 *Payment Card Handbook* and SD 931. We found that CFCH employees were sharing one administrator access user ID and password to access the POS system. This system contains payment card information. In addition, CFCH's unit designee had neither attested to CFCH's compliance with the Smithsonian's payment card policy nor attended the annual PCI training, as required by SD 309 *Payment Card Handbook*. However, CFCH informed us that they sent representatives to the 2012 training. CFCH systems process payment cards for merchandise. The major payment card brands have developed Payment Card Industry (PCI) standards for merchants and service providers to prevent payment card fraud. As a merchant, the Smithsonian must follow the PCI standards or face fines. The Smithsonian developed SD 309 along with the accompanying *Payment Card Handbook* to establish standards for accepting payment cards and securing information associated with payment card transactions.

To implement the procedures outlined in SD 309, the directive established the PCI Working Group, co-chaired by senior managers from OCIO and OC, to coordinate SI unit compliance activities. Along with other responsibilities, the PCI Working Group provides updates on compliance to Smithsonian units that are accepting or are considering accepting payment cards as a form of payment.

SD 309 outlines various responsibilities regarding PCI compliance for staff throughout the Smithsonian. OCIO is responsible for educating the Smithsonian community about data security responsibilities, as well as assisting units with implementing data security standards, including any required procedures such as vulnerability scans and periodic validation. Unit designees are responsible for ensuring that all individuals who handle or process payment card data adhere to the Smithsonian's *Payment Card Handbook* and complete an annual attestation statement indicating compliance with this directive and the Smithsonian's *Payment Card Handbook*.

In addition, the Smithsonian's *Payment Card Handbook* states that every user must use a unique user account and a personal secret password for access to Smithsonian information systems and networks. SD 931 also prohibits system administrators from establishing group accounts controlled by a single password.

Folklife staff shared one administrator user ID and password, which is the highest level of access for the POS system. The staff believed that the risk of shared access was minimal because those with administrator access generally were not processing sales transactions. However, Folklife staff used the shared access to process post-Festival sales.

In addition, the PCI Working Group had not conducted a PCI Assessment of CFCH's payment card systems since 2009, which could have brought this issue to OCIO's attention. OCIO takes a risk-based approach when assessing PCI compliance, which generally focuses on larger units that accept the majority of the Smithsonian's payment card transactions.

The lack of unique user IDs and passwords prevents CFCH from having accountability over the POS system. During the course of our audit, Folklife staff confirmed a cash transaction that was processed by someone using the shared user ID. CFCH could not determine who processed this transaction or if the proceeds were deposited into the bank. In addition, the Smithsonian is at risk of reputational harm should the integrity of customer payment card information be compromised.

Recommendations

To improve user access controls over all of CFCH's payment card systems, we recommend the Director of OCIO:

15. Direct the PCI Working Group to assess CFCH's compliance with SD 309.

We also recommend that the Director of CFCH:

16. Comply with SD 309 and implement corrective action for deficiencies identified in the PCI Working Group's assessment.
17. Ensure that the unit designee(s) attend the annual PCI training provided by OCIO.

Management concurred with recommendations 15 through 17 and has planned or taken corrective actions to address the recommendations. For recommendation 17, CFCH management provided evidence that the unit designee attended the annual PCI training. We believe that this action meets the intent of the recommendation, and we will close the recommendation effective the date of this report.

APPENDIX A. SCOPE AND METHODOLOGY

The objectives of this audit were to assess whether CFCH's accounting information systems: (1) reconcile to the Smithsonian's ERP system; (2) provide management an accurate view of CFCH's business activities; and (3) can be improved to increase efficiencies.

To accomplish our objectives, we reviewed Smithsonian directives and guidance pertinent to financial management, especially those for unit auxiliary activities. We also reviewed previous audit reports involving CFCH to identify any issues that may be relevant to the current audit objectives. Further, we examined best practices from other organizations.

We evaluated the financial management controls and procedures at CFCH and conducted walkthrough interviews with staff to identify procedural strengths and weaknesses. We interviewed staff assigned to the Festival and Smithsonian Folkways Recordings. We also interviewed staff from the Office of the Comptroller, Office of the Chief Information Officer, Office of Protection Services, Office of the General Counsel, and the Office of Planning, Management and Budget.

To accomplish our objectives, we tested CFCH system records and transactions to identify internal control strengths and weaknesses.

Folklife Accounting Information Systems

We identified 585 individual participant records in the Participant Tracking System for the 2011 Festival. To assess the accuracy of data maintained in this system, we selected a sample of 20 participant records. We traced information entered into the system to source documents and verified the accuracy of payments made to Festival participants. Lastly, we traced payments to the Smithsonian's official accounting system.

We reviewed the POS system that Folklife uses to record Festival Marketplace sales and determine vendor payments. We reviewed CFCH staff reports on Marketplace sales and verified that proceeds from sales were properly recorded in the POS system and ERP. We verified whether credit card transactions recorded in the POS system reconciled to the credit card company settlement reports. We reviewed the timeliness of daily bank deposits of cash and check sales. We selected a sample of 13 invoices which represented approximately 72% of the payments made to the vendors and traced these vendor payments to ERP. Because we selected a judgmental sample, we cannot project the results to the universe of vendor payments.

We interviewed CFCH staff that use the Far Sight system as their auxiliary accounting records. Because Far Sight is not used to approve or distribute funds, capture sensitive personal information, reconcile financial activity to the Smithsonian's ERP, or record Folkways business activity we did not conduct testing of the system.

APPENDIX A. SCOPE AND METHODOLOGY (continued)Folkways' Accounting Information Systems

We interviewed personnel from Folkways and OC regarding their methods for tracking and recording inventory and accounts receivable. We compared Folkways' inventory accounting records to ERP as of September 30, 2011. Further, we reviewed Folkways' inventory projection report and the accounts receivable records for mail order sales. Lastly, we analyzed monthly reconciliations prepared by OC and accounts receivable aging summary reports from the NetSuite system.

We reconciled Folkways' sales data to reports uploaded into the royalty payment system. We traced the sales information to verify posting to the Smithsonian's official accounting system. In addition, we reviewed the Office of the General Counsel's guidance regarding Folkways' royalties payable account. Lastly, we evaluated the royalties payable balance.

To verify royalty payments to artists and mechanical licensees, we selected a judgmental sample of 49 artist royalty payments and 10 mechanical licensee payments made in the second half of 2011. These payments represented approximately 75% of the total amount paid to artist royaltors and 93% of the total amount paid to mechanical licensees. We reviewed supporting documentation to determine whether payments were made in accordance with contractual agreements and recorded sales. We also verified that there was a valid reason why no payments were made for certain royaltor accounts. Because we selected a judgmental sample, we cannot project the results to the universe of royalty payments.

We conducted this performance audit in Washington, D.C., from September 2011 through June 2012, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX B. MANAGEMENT'S RESPONSE



Smithsonian Institution

Under Secretary for Finance and Administration and Chief Financial Officer

Memorandum

Date: September 5, 2012

To: Scott Dahl, Inspector General
Michael Sinko, Assistant Inspector General for Audits

cc: Richard Kurin, Under Secretary for History, Art, and Culture
Judith Leonard, General Counsel
Daniel Sheehy, Director, Center for Folklife and Cultural Heritage
Andrew Zino, Comptroller
Deron Burba, Chief Information Officer
Bruce Dauer, Deputy Under Secretary for Finance and Administration

From: Albert Horvath, Under Secretary for Finance and Administration and Chief Financial Officer 

Subject: Response to the Draft Audit Report: The Center for Folklife and Cultural Heritage (CFCH) Needs to Improve Its Financial Management Operations

Background: As reflected in its Draft Audit Report, dated August 21, 2012, the Office of Inspector General made seventeen recommendations to ensure the following:

- Reconciliation of CFCH accounting records to ERP and the provision of an accurate view of its profitability for management,
- Improvement in internal controls over Festival Marketplace activities, and
- Improvement of management over financial activities and the strengthening of CFCH user access controls over systems that accept payment cards

Response: This is a consolidated response that incorporates feedback from CFCH, OC, OUSHAC and OCIO. The Institution concurs with the conclusions and recommendations presented in the draft report, and we have already commenced, and in several cases completed, corrective actions to address the report's findings. Specific actions to address the seventeen recommendations are presented below.

Recommendation 1: Provide technical assistance to the Director of CFCH to determine the appropriate application of the average cost method used to value Folkways' inventory.

Action: OC staff, in conjunction with contractors hired by CFCH, will provide technical assistance to the Director, CFCH, on the proper application of the average cost method to Folkways' inventory. This is anticipated to be accomplished by October 31, 2012. Ongoing assistance will be essential to ensure that the method is sound and results are accurate as determined by OC.

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APPENDIX B. MANAGEMENT'S RESPONSE (continued)

Recommendation 2: Develop and implement policies and procedures for the selected application of the inventory method. These policies and procedures should include aging thresholds used to write-off inventory. Ensure that staff receive proper training regarding the inventory method selected.

Action: Folkways will develop and implement the necessary policies and procedures including staff training by September 30, 2013. Given the Folkways commitment to making its entire catalog available in perpetuity, the complexities of developing a policy for aging inventory may require significant consultation with other Smithsonian offices and external legal and/or accounting expertise.

Recommendation 3: Review and research current inventory documentation to identify actual account balances. If necessary, rebuild the accounts to accurately reflect assets.

Action: Folkways will review and research current inventory documentation. All account balances are expected to be resolved by October 15, 2012. If rebuilding accounts in NetSuite is necessary, it will require additional training and/or external expertise, which could delay completion until September 30 2013.

Recommendation 4: Revise staff performance plans to include requirements to ensure accuracy of prepared financial information.

Action: Folkways will revise staff performance plans by November 30, 2012 (the deadline for implementation of FY 2013 performance plans).

Recommendation 5: Review and research NetSuite accounts receivable to identify actual account balances. If necessary, rebuild the accounts to accurately reflect assets.

Action: Folkways will review and research NetSuite accounts receivable by October 15, 2012, and, if necessary, rebuild the accounts by September 30, 2013.

Recommendation 6: Revise the Folkways Mail Order Manual to include policies that identify aging thresholds used to write-off accounts receivable. Submit the revised policy to OC as required by the Smithsonian *Financial Management Accounting Policies and Procedures Handbook*.

Action: The Mail Order manual has been revised as recommended. Folkways will submit the revised policy to OC by October 15, 2012.

Recommendation 7: Direct Folkways staff to meet with OC personnel to improve the process for accurately preparing CRVs and other unit generated journal entries.

Action Complete: Folkways and OC staff have already met periodically to improve this process. We plan to meet monthly to ensure continued communication, collaboration, and an improved process that achieves desired accuracy.

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APPENDIX B. MANAGEMENT'S RESPONSE (continued)

Recommendation 8: Suspend the Memorandum of Understanding, *Treatment of Folkways Fund 420 Unit Business Activity Year-End Assets* until Folkways' accounting records accurately reflect Folkways' profitability as defined by the Comptroller.

Action Complete: The MOU was suspended in July 2012. Reinstatement of the MOU will be considered once inventory and accounts receivable are reconciled.

Recommendation 9: Formalize and implement procedures to document incoming inventory and ensure that all products are entered in the POS system prior to sale.

Action Complete: Procedures were formalized and implemented for the 2012 Festival Marketplace. OC has subsequently made additional recommendations that will be implemented prior to the next Folklife Festival in June 2013.

Recommendation 10: Formalize and implement inventory close-out procedures for vendor accounts.

Action: OC staff visited the 2012 Festival to review the application of policy and procedures and has submitted a Marketplace Operations Compliance Review that includes several recommendations to improve operational procedures. CFCH is working with OC on Folklife Festival Inventory procedures to make sure all meet OC Financial Policies and Procedures standards. The Director, CFCH, will ensure that close-out procedures for vendor accounts are formalized and implemented for the next festival.

Recommendation 11: Revise *Smithsonian Cash Handling Guidelines for Concessionaires and Marketplace Operations* to include a requirement for daily cash deposits.

Action: OC Policy and Procedures Division will revise the current guideline document by September 30, 2012 to include a requirement for daily cash deposits. The requirement for daily cash deposits will include exceptions for the 4th of July holiday and other circumstances when a security risk and/or risk to the well-being of staff make cash deposits inadvisable.

Recommendation 12: Ensure that Festival staff make daily deposits in accordance with the revised guidelines.

Action Complete: Deposits were made daily during the 2012 Festival with exceptions as noted in response to recommendation 11.

Recommendation 13: Develop and implement additional written policies and procedures for key financial activities.

Action: CFCH will develop and implement additional policies and procedures by September 1, 2013. This process requires ample time for careful analysis of needs, as well as consultation with other Smithsonian offices.

Recommendation 14: Develop cross-training plans to address potential staff turnover and absence.

Action: CFCH will develop and implement cross-training plans by September 1, 2013. Similar to Recommendation 13, this process requires ample time for careful analysis of needs, as well as consultation with other Smithsonian offices.

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APPENDIX B. MANAGEMENT'S RESPONSE (continued)

Recommendation 15: Direct the PCI Working Group to assess CFCH's compliance with SD 309.

Action: An assessment of each of the credit card processing environments operated by CFCH is being performed as part of the PCI Working Group's FY 2012 PCI compliance assessment cycle. The compliance assessment evaluates the Unit's compliance with PCI requirements and SD 309.

Recommendation 16: Comply with SD 309 and implement corrective action for deficiencies identified in the PCI Working Group's assessment.

Action: Action has already been taken on the PCI system for the Festival and all identified deficiencies have been remedied. Once a PCI assessment has been completed for Folkways, any additional deficiencies will be remedied as quickly as possible.

Recommendation 17: Ensure that the unit designee(s) attend the annual PCI training provided by OCIO.

Action Complete: CFCH designee attended the 2012 training on May23.

Based on the foregoing, I request closure of recommendations 7, 8, 9, 12 and 17.

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APPENDIX C. SCHEDULE FOR COMPLETION OF AUDIT RECOMMENDATIONS

Rec #	Recommendation	Target Completion Date
Finding #1: The Folkways Profit and Loss Statement is Not Reliable		
1.	Provide technical assistance to the Director of CFCH to determine the appropriate application of the average cost method used to value Folkways' inventory.	10/31/2012
2.	Develop and implement policies and procedures for the selected application of the inventory method. These policies and procedures should include aging thresholds used to write-off inventory. Ensure that staff receive proper training regarding the inventory method selected.	9/30/2013
3.	Review and research current inventory documentation to identify actual account balances. If necessary, rebuild the accounts to accurately reflect assets.	9/30/2013
4.	Revise staff performance plans to include requirements to ensure accuracy of prepared financial information.	11/30/2012
5.	Review and research NetSuite accounts receivable to identify the actual account balances. If necessary, rebuild the accounts to accurately reflect assets.	9/30/2013
6.	Revise the Folkways Mail Order Manual to include policies that identify aging thresholds used to write-off accounts receivable. Submit the revised policy to OC, as required by the Smithsonian <i>Financial Management Accounting Policies and Procedures Handbook</i>	10/15/2012
7.	Direct Folkways staff to meet with OC personnel to improve the process for accurately preparing CRVs and other unit generated journal entries.	Closed
8.	Suspend the Memorandum of Understanding, <i>Treatment of Folkways Fund 420 Unit Business Activity Year-End Assets</i> until Folkways' accounting records accurately reflect Folkways' profitability as defined by the Comptroller.	Closed
Finding #2: Financial Management of the Festival Marketplace POS System Needs Improvement		
9.	Formalize and implement procedures to document incoming inventory and ensure that all products are entered in the POS system prior to sale.	8/30/2013
10.	Formalize and implement inventory close-out procedures for vendor accounts.	8/30/2013

**APPENDIX C. SCHEDULE FOR COMPLETION OF AUDIT RECOMMENDATIONS
(continued)**

Rec #	Recommendation	Target Completion Date
Finding #3: Folklife did not Make Timely Cash Deposits of Sales from the Festival Marketplace		
11.	Revise Smithsonian Cash Handling Guidelines for Concessionaires and Marketplace Operations to include a requirement for daily cash deposits.	Closed
12.	Ensure that Festival staff make daily deposits in accordance with the revised guidelines.	Closed
Finding #4: CFCH Needs to Improve Management Over Financial Activities		
13.	Develop and implement additional written policies and procedures for key financial activities.	9/1/2013
14.	Develop cross-training plans to address potential staff turnover and absence. This plan should include opportunities to cross-train staff to mitigate risks caused by resource constraints.	9/1/2013
Finding #5: CFCH is not Following Password and Payment Card Policies		
15.	Direct the PCI Working Group to assess CFCH's compliance with SD 309.	10/31/2012
16.	Comply with SD 309 and implement corrective action for deficiencies identified in the PCI Working Group's assessment.	12/14/2012
17.	Ensure that the unit designee(s) attend the annual PCI training provided by OCIO.	Closed

APPENDIX D. CONTRIBUTORS TO REPORT

The following individuals from the Smithsonian Office of the Inspector General contributed to this report:

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