

THE TECH MUSEUM OF INNOVATION

**Management Letter Recommendations
Year Ended December 31, 2003**

May 2, 2004

Audit Committee
The Tech Museum of Innovation
145 San Carlos Street
San Jose, CA 95113

During the planning and testing stages for all audit engagements, we take into consideration internal control structure and how it functions to determine the extent of procedures we will use to conduct our audit. The intended purpose is not designed to provide absolute assurance related to the internal control structure but to bring matters to management's attention that can improve operating and reporting conditions. Any system improvements can translate into increased efficiency for the Organization.

Enclosed is a list of the issues that we encountered during our work together with our recommendations for their resolution.

We will be happy to assist you or your staff in any way to implement our recommendations. If you would like to discuss these matters further, please do not hesitate to call.

Very truly yours,

Ireland SanFilippo LLP

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CURRENT YEAR COMMENTS:

1. General ledger

Observation:

The GL is a system by American Fundware which was acquired in 2002 by Intuit. Since that time there have been software upgrades installed to allow for more effective project based costing analyses. Up to date system maintenance should be part of the allocated maintenance budget for the accounting department as a matter of course. However, there may be more system improvements that can be made once an analysis of the current operating environment has been undertaken.

Recommendation:

We recommend the Audit Committee approve a thorough review of the accounting systems. Any required or requested system enhancements should be approved by the Committee before being undertaken to ensure the Committee has oversight of the systems involved in financial recording. This is a fiduciary duty of the Board and Audit Committee.

Observation:

Per review of the trial balance, it was noted the Organization has “payable(receivable) between net assets categories” set up from when The Tech first opened its doors. The amounts net to zero but per inquiry, there are no amounts truly due to or due from the various funds listed.

Recommendation:

When The Tech first opened, not-for-profit entities maintained its accounts under the fund accounting system. With the implementation of Statement of Financial Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, although the use of fund accounting is not prohibited or required, it does require providing information about three classes of net assets: (a) restricted, (b) temporarily restricted, and (c) unrestricted. Fund accounting may not accomplish the goal of informing the reader about donor restrictions, as required by SFAS 117, and merely accounting for transactions in a separate fund does not satisfy the requirement. It is recommended The Tech review its chart of accounts, adjust the balances against net assets and close those funds that are not being used.

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2. Bank reconciliations

Observation:

Through early 2003, the bank reconciliations were being completed several months after the periods to which they related before Terry Boyle started reviewing the operations. Since then, the system has been tightened up and reconciliations are performed regularly and as early as possible. There has been a consistent unidentified difference on the reconciliations since the middle of 2003. This difference may be effectively unidentifiable at any reasonable effort or cost as it appears to relate back to periods before December 2002. The difference was consistent from November 2003 to December 2003 and was written off as part of the December 2003 adjustments.

Recommendation:

We recommend that the bank reconciliations continue to be completed in a timely manner. Any unidentified differences should be maintained on the books for a reasonable period of time to allow for proper investigation. Any differences on an ongoing basis should be brought to the Audit Committee for write-off approval if they are over a certain threshold, to be set by the Committee at their discretion.

3. Inventory

Observation:

The Museum has been experiencing retail store losses of about 3% per year traditionally. With the hiring of a new Director of Operations in late 2003 and the subsequent implementation of new retail store techniques the Museum hopes to reduce the "shrinkage" greatly over 2004. For 2003, the shrinkage was 5.5% whereas the general stores within similar museum environments experienced shrinkage between 1.5% and 2%.

Recommendation:

Shrinkage is an operational issue across all areas of retail. We recommend that the Museum implement additional procedures to deter against future shrinkage such as installation of cameras in the store. Currently, there are cameras over the cash register.

Observation:

While reconciling the detailed inventory for the Museum's store to the ledger, it was noted there was a variance due mainly to the fact the physical inventory was taken approximately fifteen days after year end. Consequently, the inventory had to be rolled back to December 31, 2003 numbers.

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3. Inventory (continued)

Recommendation:

It is recommended the physical inventory be counted as close to the end of the fiscal year as possible. In doing so, this will eliminate any errors that can occur when rolling the count back to the end of the year. Additionally, after the physical count has been taken, any discrepancies between the count and the ledger should be investigated and the ledger adjusted to the physical count. The Tech may also want to consider periodic cycle counts for the high dollar items.

4. Fixed assets

Observation:

The Museum keeps track of fixed assets using FAS software. The fixed assets register is an area that had not received regular review until Terry's hiring in 2003. As part of the preparation for the audit, Terry and his staff were to review the entire FAS report to identify and write off obsolete, damaged and previously disposed of assets.

Recommendation:

We recommend that such a review be carried out at regular intervals with a physical inventory of assets performed for 2004.

Observation:

Another issue for fixed assets, relating specifically to non-profit organizations, is the valuation of donated fixed assets. The donor has the opportunity to value assets given to the Museum. The valuation may impact the tax deduction to be taken by the donor and as such the donor has a bias to increase the declared value of the goods to the maximum allowable. The Museum, if recording the assets at the declared value, may then "suffer" from high depreciation expenses relating to that asset for many future periods.

Recommendation:

We recommend that the Museum staff carefully review the value at which donated assets are to be recorded in the Museum books. For large donations, third party appraisals should be requested. For other assets, comparisons to known sources of resale may be possible, such as auction houses, including on-line resources. Donations of new assets should be compared to manufacturer's catalogs taking into account the usual customer discount rates allowed.

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4. Fixed assets (continued)

Observation:

While reconciling the detail of fixed assets to the general ledger, it was noted the Organization had been carrying an amount classified as "Genetics Collection" for \$12,750. Upon inquiry, this amount has been carried on the Organizations ledger for several years. It is recommended this amount be researched to substantiate the carrying amount, if possible. Otherwise, the matter should be brought up to the audit committee to consider writing off this amount in the upcoming fiscal year.

5. Employee manual

Observation:

Although there is an employee manual given to new employees as part of the new hire process, there is no museum-wide training relating to areas of ethics and fraud. These areas are left to each employee's manager to convey to their staff. Staff is required to receive training in areas such as harassment and discrimination. Staff signs no conflict of interest policies.

Recommendation:

We recommend that a system of employee training be implemented to include ethics and fraud in addition to other required human resources training obligations. For all Board members, Audit Committee members, Directors and staff, a conflict of interest policy should be discussed and signed. This increases the focus on behavior patterns related to the good of the non-profit as a whole while accepting that conflicts of interest do arise and need to be dealt with in an appropriate and realistic manner.

6. Organization policies

Observation:

Per review of the organizations policies regarding processing of receipts, disbursements, purchase orders, and asset capitalization, it was noted most were dated in 1998.

Recommendation:

It is recommended the Organization review all of its policies to ensure they have been updated for changes over the prior five years and are revised as needed on an annual basis. The Organization should have all policies and procedures in one manual for ease of access and all personnel should be made aware of all of the Organization's policies so they are followed regularly.

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7. Investments

Observation:

Upon review of the investments it was noted realized gains/losses were netted with unrealized gains/losses on the trial balance. Per review of the investment policy and inquiry of management, it was noted the investment policy was not being adhered to. Specifically, the portfolio is concentrated with one investment manager who is not actively pursuing the best investment strategy for The Tech as is stipulated in the policy. It is The Tech who is being proactive and advising the investment manager where to invest their funds.

Recommendation:

It is suggested that realized and unrealized gains/losses be segregated on the trial balance as opposed to being netted. In doing so, the gross amount of each is readily visible and the appropriate information can be easily obtained. We also strongly recommend the investment policy be reviewed and the organization research other investment managers to ensure The Tech's investments are handled properly and the best return on its funds be obtained. The investment policy is crucial since there is a significant amount of resources invested with the investment manager.

8. Earnings classification between restricted and unrestricted

Observation:

All earnings are entered into the accounting system initially as unrestricted (except for Endowment pledges received) and are then reviewed to determine whether any items relate to future dates or events. In such cases, items of income are then reallocated as necessary to temporarily restricted categories.

Recommendation:

We recommend that all items of income should be reviewed and allocated directly to temporarily restricted or restricted funds, if applicable, as soon as they are entered into the system. This will reduce that chance that such items will not be correctly allocated during a later review. The system should be able to allow such categorization of income.

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9. Contributions

Observation:

Contributions from individuals almost always hit current year earnings; the Museum has not solicited pledges from individuals since the endowment campaign (which was in fact aimed more at corporations and foundations). If pledges exist, then Terry Boyle reconciles the reports given to him by the Development department with the contributions he received.

Recommendation:

We recommend that the Development and Accounting departments develop a consistent system to allow both to use one database to record and review pledges. The wording of pledges should be such that the pledge intention is unmistakable and the period over which the pledge is to be paid should be clear. After this has been achieved, pledges should be recorded in the accounting records in a manner consistent with FAS 116, *Accounting For Contributions Received*.

Observation:

During 2003, the Organization conducted joint activities that were partly a fund-raising function and partly another function (for example, program, management and general, or membership development function). Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, requires the evaluation of the following, in order, to determine if the purpose criterion has been met for joint activities so the allocation of joint costs can be determined:

- Whether compensation or fees for performing the joint activity are based on the amount of contributions raised
- Whether a similar program or management and general activity is conducted separately and on a similar or greater scale
- Whether other evidence indicates that the purpose criterion is met

For the two fundraisers in 2003 (GIZMO and the Tech Awards) the purpose criterion was met since compensation or fees for performing the joint activity are not based on the amount of contributions raised. In addition, the program component of the joint activity calls for specific action by the recipient that will accomplish the Organization's mission and the Organization conducts that program component without the fund-raising component in a different medium. As such the costs should be allocated between fund-raising and the appropriate program or management and general function.

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9. Contributions (continued)

Recommendation:

Since the direct fundraising costs in 2003 were \$748,327 which accounts for only 3.9% of the total 2003 expenses of \$19,190,539, it was determined the cost of accounting for the indirect costs allocable to the fundraising would far exceed the benefits. Granted the total expenditures were immaterial when looking at the total expenses for the year, however, this may not be the case in future years. It is recommended, management consider implementing procedures to be able to allocate the indirect costs of the joint activity as a fund-raising expense.

10. Audit Committee

Observation:

The Audit Committee has responsibility for financial matters.

Recommendation:

We recommend that the Audit Committee review its policies and procedures to ensure that its fiduciary care of the Museum is as complete as possible. Areas to consider include:

- Developing a mission statement and code of ethics for members
- Updating of Board composition to include industry specialists
- Reviewing employee training in ethics, fraud and whistleblower protection
- Testing the whistleblower reporting system to ensure it is truly anonymous
- Reviewing the finance departments risk evaluation systems – business and fraud risk
- Reviewing reports to be provided to the Board, including industry statistics or other benchmarking information

11. Grant Agreements

Observation

During our review of compliance with grant agreement, it was noted reports to be filed in compliance with grant agreement had not been filed with the appropriate agency.

Recommendation

All grant agreements should be monitored regularly to ensure compliance. It is suggested once a grant is received, it be reviewed for conditions of compliance. For those that require reports to be filed, the individual delegated the responsibility for this task should mark it on their calendar, as should their immediate supervisor.

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12. Federal Grants

Observation:

It was observed during our testing of compliance of federal grants, that the file containing all the relevant data did not have an executed grant agreement, a grant award or conditions of the grant. It was noted, the file contained various e-mails for the granting agencies stipulating the award amount, the approved budget, and some grant specific conditions.

Recommendation:

If the Organization is to continue applying for federal funding, it is recommended the federal grant files be complete with executed agreements. If, as in the case of the 2003 federal grants received, all communiqué was via e-mail, the Organization should request in writing specifics as to where the funding can and cannot be spent. In doing so, the Organization has taken measures to ensure they comply with the grant conditions and avoid any potential situations where the granting agency denies claims for reimbursement. If this were to happen, future funding could be jeopardized, as granting agencies will look to see if the applicant has had instances of non-compliance in the past as it related to federal funding.

For the upcoming fiscal year, the threshold for determining whether the Organization will require an audit in compliance with the Single Audit Act has been increased from \$300,000 to \$500,000 of expenditures of federal awards.

13. Benefits Plan

Observation:

As part of the Organization's defined contribution plan, there is an annual Form 5500 that is required to be filed. In addition, if the Organization's eligible participants is greater than 100, the plan may require an independent audit. It was noted the Form 5500 filed for this plan was incomplete and did not appear to contain the pertinent data required. Furthermore, the number of eligible participants exceeded 100 for the 2003 year.

Recommendation:

The Organization should contact the entity responsible for preparing the Form 5500 to ensure that it was filed properly, and a copy of the Form that was actually filed should be obtained for the Organization's records. In addition, the Organization should inquire of the administrator as to the need for an audit of the plan. The plan audit, if required, would be due by July 31 or, if extended, by October 31 following the end of the fiscal year. We would be happy to discuss the particulars of an audit with you.

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14. **Payroll records**

Observation:

During our review of The Tech's employee personnel file, it was noted the Employment Eligibility Verification Form (I-9) for one employee was not available to review and one was not signed by the authorized representative.

Recommendation:

It is suggested that all employment forms be completed and retained by the human resource department prior to the start date of any employee to ensure The Tech is hiring eligible employees.

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STATUS OF PRIOR YEAR COMMENTS:

1. Tracking and reconciling contributions and temporarily restricted net assets

Observation:

The Organization has a database of contributions received, receivable and collected via the Blackbaud/Razor's Edge software maintained by the development department. This database is very important to the finance department because it serves as the method to communicate the existence of contributions, pledges, pledge payments and any donor-imposed restrictions. We noted that the data in this database is not reconciled to contribution data recorded in the general ledger on a regular basis and much of it is reconciled only at the end of the year. This reconciliation was still ongoing during our audit fieldwork.

Contribution accounting in the general ledger is maintained on a cash basis during the year and converted to an accrual basis as part of the year-end close. As a result, the pledges receivable and revenue recognition in the interim months does not conform with generally accepted accounting principles.

The finance department tracks temporarily restricted net assets (unused donor-restricted funds) in a spreadsheet which rolls-forward restricted activity, by donor, from month to month. While this reconciliation had been maintained, we noted that the associated general ledger accounts had not been updated to reflect the activity when we commenced the audit. We were also informed that the date in the reconciliation was inconsistent with the data reported to the financial committee. The accuracy of temporarily restricted net asset accounting and reporting is especially critical to The Tech in the current environment when the Organization is borrowing those restricted monies to fund current operations. The extent of borrowing and the repayment plans must be accurately tracked and that cannot be done without having accurate information about the extent of temporarily restricted net assets.

Recommendation:

We recommend that the Organization begin reconciling the donor database to the general ledger on a monthly basis. We also suggest recording contribution general ledger activity on an accrual basis not only at the end of the year, but also during the year. Management has expressed a desire to report all interim financial data on an accrual basis so this change would facilitate that initiative. Finally, we recommend that the receipt and use of donor-restricted funds be recorded in the associated general ledger accounts each month and that extra care be taken to report accurate temporarily restricted net asset balances and borrowing to the finance committee.

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1. Tracking and reconciling contributions and temporarily restricted net assets (continued)

Current Status:

Reconciliations are being performed monthly and written pledges are recorded on an accrual basis upon receipt. The project/grant module of the new accounting system was installed in November and the general ledger is being update to reflect the year-to-date activity.

2. Unconditional v. conditional promises to give/revenue recognition

Observation:

Statement of Financial Standards No. 116, *Accounting for Contributions Received and Contributions Made*, calls for organizations to record as assets and revenue, "unconditional promises to give," commonly referred to as pledges receivable. SFAS 116 states that in cases of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional shall be presumed to be a conditional promise and therefore not recognized as contribution revenue until the condition has been substantially met. This distinction is becoming more and more relevant to The Tech and other not-for-profit organizations in the current environment. Due to economic conditions, some donors are qualifying their existing commitments as well as new contributions with such wording as "it is out *intent* to give these funds..." or "we commit these funds to the Organization *subject to...*". We encountered just such a situation at The Tech during the audit which required consulting with the donor regarding further clarification.

Recommendation:

We recommend that the Organization carefully review donor correspondence for such conditional wording and encourage management to contact (preferably in written form) the donor in these situations to further clarify the donor's commitment before recording revenue. We also recommend The Tech consider strengthening the wording in its existing pledge forms and using the phrase, "unconditional promise to give."

Current Status:

This recommendation has been implemented. Existing pledge forms will not be modified to incorporate the phrase "unconditional promise to give" due to cultivation reasons.

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3. Borrowing donor-restricted funds

Observation:

The Organization's unrestricted net assets have been diminishing for several years. To help pay for operational expenses, the Organization has borrowed from its donor-restricted funds.

Recommendation:

We strongly encourage the Organization to seek other sources of cash to fund operations. Borrowing from funds restricted by donors for other purposes can be considered a violation of the donor's restriction unless that borrowing was done with the permission of the donor(s). A donor always has the option to ask for their donation back if it has not been used in accordance with their wishes. We have noted that management has a plan in place to reduce this type of borrowing in forthcoming year and we encourage The Tech to keep this initiative a top priority.

Current Status:

Fiscal year 2003 was projected to be a positive cash flow but not sufficient enough to eliminate prior years' debt. The Tech utilized the bank line of credit in lieu of borrowing donor-restricted funds as of year-end to fund this debt.

4. Opportunity for increased efficiencies within the accounting department

Observation:

The Organization maintains certain sub-ledgers and reports using Excel, such as fixed asset and accounts payable sub-ledgers and summarized financial reports, among others. Although Excel is a very useful tool, the Organization should utilize their accounting software to maintain these sub-ledgers and prepare reports. The accounting software should be integrated with the sub-ledgers and have report writing capabilities. The manual system currently being used can be time consuming and prone to errors.

Recommendation:

The general ledger system, American Fundware, is equipped to run certain reports (i.e. accounts payable aging and others). By utilizing these features in American Fundware, reports can be processed on a more efficient and timely manner. Another alternative is to purchase a new accounting package or to upgrade to the current version of the existing package so that it can better suit the Organization's needs. While the current package functions, it is an older DOS-based system which is not efficient.

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4. Opportunity for increased efficiencies within the accounting department (continued)

Current Status:

This recommendation has been implemented by upgrading the DOS version to the most recent Windows-based version.

5. Computer environment/segregation of duties

Observation:

Within the finance department, employees are given a unique computer user identification number, but only one password is established amongst all users. Additionally, access to different components of the general ledger system is not segregated between employees. This allows any employee to enter any component of the general ledger system, which may encourage fraud and risk of potential misstatements when posting transactions into the general ledger.

Recommendation:

Management should establish user rights within the accounting software for each accounting personnel and should issue unique passwords to aid in restricting access to incompatible duties.

Current Status:

This recommendation has been implemented as part of the new accounting system upgrade.

6. Federal grants

Observation:

We understand that the Organization recently has been awarded some grants from the National Science Foundation that will benefit fiscal 2002 and future periods. As you are aware, federally funded grants come with many restrictive rules and regulations regarding allowability of costs, employee time reporting requirements, involved overhead rate and fringe benefit rate applications and reporting, among other things. When expenditures of federal monies exceed \$300,000 in a fiscal year, compliance with these rules and regulations must be tested as part of the annual audit in accordance with the Single Audit Act Amendment of 1996 and OMB Circular A-133, *Audits of States, Local Governments, and Non-for-Profit Organizations*.

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6. Federal grants (continued)

Recommendation:

Being that the Organization has not had a large volume of federal grants in the recent past yet sees this revenue source as a significant opportunity for the future, we recommend the Organization establish an infrastructure to administer a grants management function. In its early stages, this would involve designating an existing employee as the grants management specialist, providing some training regarding OMB Cost Circulars and other federal regulations and establishing an internal control environment to ensure compliance. As the volumes of grants increases, this function may become a full-time position. We would be happy to recommend certain training courses and resource manuals that should facilitate this process

Current Status:

This recommendation has not been implemented as of the end of 2003. As part of the 2004 budget, a grant writer and a senior manager were incorporated into the staffing plan. The grants management infrastructure was re-organized under the auspices of the Development Department.

7. Payroll processing

Observation:

It was observed that the payroll accountant sets up employees and transmits bi-weekly payroll to the service provider. This same individual also receives the bi-weekly payroll summary reports and payroll checks, and direct deposit advices directly from the service provider.

Recommendation:

There appears to be a lack of segregation of duties with the payroll cycle. We recommend someone other than the individual responsible for preparing the payroll and recording payroll entries, actually receive payroll checks for distribution. We also recommend that a formal process be developed whereby changes to employee information be submitted to ADP (e.g., salary, name, address) are approved by someone other than the individual responsible for processing payroll.

Current Status:

The Senior Director of Human Resources is performing periodic reviews of the actual ADP payroll checks and reports against a separate master employee database independently maintained from the staff member responsible for payroll processing and is indicating this by initialing the payroll reports.