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United States Department of State
and the Broadcasting Board of Governors
Office of Inspector General

Office of Audits

Independent Accountants' Report on the Application of Agreed-Upon Procedures on Indirect Cost Rates Proposed by Scholastic, Inc.

Report Number AUD/CG-06-20, March 2006

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SUMMARY

At the request of the Department of State (Department), Bureau of Administration, Office of Logistics Management, Office of Acquisitions Management (A/LM/AQM), the Office of Inspector General (OIG) contracted with L.F. Harris & Associates, CPA, P.A., to perform agreed-upon procedures on Scholastic, Inc.'s (Scholastic) indirect cost rates for its fiscal years ended May 31, 2005 and 2004, to determine whether the rates and cost principles used were in compliance with Office of Management and Budget (OMB) Circular A-122, Cost Principles for Non-Profit Organizations.

Scholastic's general ledger system did not capture direct and indirect expenses in a manner that effectively identified appropriate indirect cost pools as required by OMB Circular A-122. Scholastic also did not utilize a job cost system that segregates cost into direct and indirect costs, which includes the distribution of labor between direct and indirect classifications. However, Scholastic maintained comprehensive and detailed support for its program expenses. As a result, Scholastic was able to provide adequate documentation to compute the rates.

We recommend that A/LM/AQM require Scholastic to develop a comprehensive Indirect Cost Allocation Plan and maintain a comprehensive job cost accounting system that captures indirect pools and uses appropriate allocation methods. The plan should conform to OMB Circular A-122 and Federal Acquisition Regulation Part 31.2, Contracts With Commercial Organizations.

We discussed these review results with Scholastic's management on September 8, 2005. We received Scholastic's comments on a draft report on October 13, 2005. (See Appendix A.) This report discusses the findings in detail and presents our recommendations for resolution of the findings.

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BACKGROUND

Scholastic is the largest publisher and distributor of children's books and is the largest operator of school-based book clubs and book fairs in the United States. It was incorporated in Delaware in 1986 and, through predecessor entities, has been in business since 1920. Scholastic employs approximately 7,200 people in full-time jobs and 1,000 people in part-time jobs inside and 2,600 outside the United States.

As a for-profit, publicly traded corporation, Scholastic established accounting and reporting procedures to comply with accounting principles generally accepted in the United States of America and Securities and Exchange Commission regulations and other governing authorities, without expectation of federal awards.

Scholastic operates with four business segments, one of which is the International Division, Export Department. Subsidiaries operate in approximately 16 countries that report financial information individually to corporate headquarters. A detailed, comprehensive general ledger is not available as each subsidiary maintains separate books and records that comply with accounting principles and regulations of each specific country and the United States of America.

Scholastic entered into a cooperative agreement with the Department, the Middle East Partnership Initiative, Arabic-Language Scholastic, Inc. Book Program; Award Number S-NEAPI-04-CA-101. Under the agreement, Scholastic received an award in the amount of \$5,932,396. Provisions V and VII of the agreement specify that indirect costs are limited to the lesser of \$1,069,776 or 22 percent of the total expended under the award. Scholastic had no prior material experience with federal awards and thus had to learn appropriate regulatory requirements.

OMB Circular A-122 establishes principles and standards for determining cost for federal awards carried out through grants, cost reimbursement contracts, and other agreements with nonprofit organizations. The principles are for the purpose of cost determination and are designed to provide that federal awards bear their fair share of costs.

The principles and standards of OMB Circular A-122 apply to both direct and indirect costs. A direct cost is a cost that can be identified specifically with a particular cost objective; e.g., Middle East Partnership Initiative Arabic-Language

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Scholastic, Inc. Book Program. Examples of direct costs include employee compensation and benefits, supplies, and travel. An indirect cost is a cost that cannot be identified with a single, final cost objective, but is identified with two or more final cost objectives, one or more of which benefits federal programs. Such costs should be combined into groups or pools and should be distributed to benefit final cost objectives in a manner that will produce an equitable result based on relative benefits derived.

A/LM/AQM gave Scholastic permission to use provisional indirect rates based on projected financials. Provisional rates are temporary rates used for funding and billing indirect costs pending the establishment of a final rate for a specified time period. The agreement includes an Arabic-Language Early Reading Program (3rd and 4th grades) that includes the following program elements:

- 6,000 classroom libraries for 2,700 schools;
- 40 titles, five copies of each;
- 1.2 million new books into classrooms;
- Train the Trainer professional development workshops and classroom teacher training and support; and
- public diplomacy and community outreach activities.

The agreement specifies that Scholastic is subject to the requirements of OMB Circulars A-122; A-110, Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations; and A-133, Audits of States, Local Governments, and Non-Profit Organizations, Appendix B, Compliance Supplement.

Section 26(d) of OMB Circular A-110 states that “commercial organizations shall be subject to audit requirements of the Federal awarding agency or the prime recipient as incorporated into the award document.”

PURPOSE, SCOPE, AND METHODOLOGY

The primary purpose of this agreed-upon procedures engagement was to review Scholastic's indirect cost rates for its fiscal years ended May 31, 2005 and 2004, to determine whether the rates and cost principles used were in compliance with OMB Circular A-122.

We designed our approach to determine compliance with OMB Circular A-122, which describes selected cost items, allowable costs, and standard methodologies for calculating indirect cost rates for nonprofit organizations. The purposes of OMB Circular A-122 are:

- to ensure that the federal government bears its fair share of costs;
- to identify allowable costs for determining the actual cost of federal programs; and
- to establish policies and procedures for indirect cost allocation plans.

Our procedures included determining that:

- charges to cost pools used in calculating indirect cost rates were allowable costs per OMB Circular A-122;
- the methods of allocating costs were in accordance with the cost principles contained in OMB Circular A-122, and they produced an equitable and consistent distribution of costs;
- indirect cost rates were applied in accordance with approved indirect cost rates; and
- the final Indirect Cost Allocation Plan and the final indirect cost rates were prepared in compliance with requirements of OMB Circular A-122.

We conducted the following procedures:

1. We obtained an understanding of internal control, made an assessment of risk, and tested internal controls as required by generally accepted government auditing standards.

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2. Direct Costs - We determined whether the organization complied with the provisions of OMB Circular A-122 as follows:
 - a. tested direct charges to federal awards for allowability; and
 - b. verified that unallowable costs, determined to be direct costs, were included in the allocation base for the purpose of computing an indirect cost rate.

3. We tested indirect costs to determine whether:
 - a. the base used to distribute the approved allowable indirect cost was appropriate and reasonable and in accordance with the requirements of OMB Circular A-122;
 - b. the calculated indirect cost rate (i) was consistent with policies and procedures that apply uniformly to both federally funded and other activities of the organization, and (ii) applied consistently to the proper allocation bases; and
 - c. the organization complied with the provisions of OMB Circular A-122 as follows:
 - i. charges to indirect cost pools were for allowable costs;
 - ii. the base used to distribute indirect costs included both allowable and unallowable costs; and
 - iii. the cost allocation methodology provided equitable and consistent allocation of indirect costs to benefiting awards or activities.

4. We tested corporate and division costs to determine whether allocated charges from corporate and division cost pools to the program were in accordance with OMB Circular A-122.

The scope of detail testing of individual accounts, internal controls, direct costs, indirect costs, regulation compliance (such as A-133 audit requirements), and other applicable records are a matter of judgment. Auditors cannot assume responsibility for fraud detection or prevention. Auditors are expected to maintain an alertness that will permit adequate inspection of the financial records as well as the

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internal controls, internal accounting, and administrative controls. As such, the auditors were alert to the possibility of intentional wrongdoing, errors and omissions, inefficiency, waste, ineffectiveness, and conflicts of interest.

We conducted the testing and assessment at Scholastic's office in New York, NY, from May 9 to May 13, 2005, and from August 10 to August 12, 2005.

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AGREED-UPON PROCEDURES RESULTS

We identified one finding of noncompliance with the agreement and regulations. OMB Circular A-122, Attachment A states that where an organization's indirect cost benefits its major function in varying degrees, direct and indirect cost grouping must

be established so as to permit the allocation of each grouping on the basis of benefits provided to the major functions. Each grouping shall constitute a pool of expenses that are of like character in terms of functions they benefit and in terms of the allocation base which best measures the relative benefits provided to each function.

Scholastic's general ledger system did not capture direct and indirect expenses in a manner that effectively identified appropriate indirect cost pools as required by OMB Circular A-122.

Difficulties Encountered

1. We encountered difficulties balancing overhead rate calculations provided by Scholastic to audited corporate financial statements. However, we were able to reconcile to the financials with immaterial differences.
2. Direct and indirect labor costs were combined in the general ledger. Scholastic did, however, track direct labor costs for federal awards and provide additional analysis on indirect labor.
3. Written procedures regarding the allocation of indirect expenses were vague, making it difficult to understand the allocation methods utilized.

Conclusions

1. We were able to calculate a general and administrative (G & A) indirect cost rate for Scholastic.

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2. In performing our procedures to test the indirect cost rates, we recomputed the allocation of Scholastic’s Corporate and International Division’s G & A expenses allocated to the Export Department in Scholastic’s International Division and recomputed the indirect rate for the Export Department itself for FYs 2005 and 2004. As a result, we determined that Scholastic had included unallowable costs in its G&A pool, that is, costs that are allowable as indirect costs under generally accepted accounting principles but are not allowable under OMB Circular A-122 criteria. These unallowable costs were as follows.

	2005	2004
Corporate General and Administrative Expenses	\$17,929,89	1\$15,242,878
International Division General and Administrative Expenses	1,763,416	1,585,220
Export Department	1,457,718	2,657,010
Total	\$21,151,025	\$19,485,108

After excluding these costs, we computed the following indirect cost rates.

	2005	2004
G&A Pool	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)
Base	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)
Calculated Rate	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)	(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)(b) (4)

3. The overhead percentage calculated above is over the allowable limit for the fiscal year ended May 31, 2005, under provision V of the award agreement that limits Scholastic’s indirect costs to the lower of (b) (4) or (b) (4). However, as of the completion of our agreed-upon procedures, Scholastic had not requested reimbursement for any costs under the award agreement. Therefore, even though the FY 2005 rate was over the allowable limit, there was no overbilling by Scholastic.

Recommendation 1: We recommend that the Department’s Bureau of Administration, Office of Logistics Management, Office of Acquisitions Management require Scholastic, Inc., to develop a comprehensive Indirect Cost Allocation Plan, maintain a comprehensive Job Cost Accounting System to capture indirect pools, and use appropriate allocation methods. The plan should conform to OMB Circular A-122 and Federal Acquisition Regulation Part 31.2, Contracts With Commercial Organizations.

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Among other criteria, the Job Cost Accounting System should include:

- a general ledger in which direct and indirect costs are separated and accumulated;
- a payroll system supported by time sheets that clearly identifies project and account numbers charged and direct and indirect cost accounts;
- a job cost report in which costs directly related to the specific jobs or projects are recorded;
- periodic reconciliation of job cost reports with the general ledger; and
- a schedule of indirect costs, periodically prepared in accordance with the requirements of OMB Circular A-122.

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L.F. Harris & Associates, CPA, P.A.
Certified Public Accountants

**Independent Accountants' Report on Applying
Agreed-Upon Procedures**

U.S. Department of State
Office of Inspector General
Office of Audits
1700 North Moore Street
Arlington, VA 22209

We have performed certain agreed-upon procedures, as summarized in the Scope and Methodology section of this report. The procedures, which were agreed to by the Office of Inspector General, U.S. State Department, were performed solely to assist the Office of Inspector General, U.S. State Department in evaluating Scholastic, Inc.'s computations of their indirect cost rates in accordance with Office of Management and Budget Circular A-122 for the fiscal years ended May 31, 2005 and 2004.

Scholastic, Inc.'s management is responsible for compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with generally accepted government auditing standards and attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures as described in the Scope and Methodology section of this report either for the purpose for which this report has been requested or for any other purpose. Our test procedures revealed one finding. The finding and the associated recommendation are presented in the Agreed-Upon Procedures Results section of this report. We have also presented an observation that we noted during the performance of the procedures and made a recommendation regarding A-133 audit requirements.

We were not engaged to, and did not perform an audit, the objective of which would be the expression of an opinion on the total costs claimed. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the use of the Department of State, Office of Inspector General, and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

L.F. Harris & Associates, CPA, P.A.
December 15, 2005

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Comments From Scholastic Inc.

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Date: October 12, 2005

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RE: Agreed-Upon Procedures on Indirect Cost Rates
Report Number: _AUD/CG-06XX
Date: _August 27, 2005 _____

To Whom It May Concern:

On September 8, 2005, Scholastic, Inc. received a copy of "The Agreed-Upon Procedures on Indirect Cost Rates Proposed by Scholastic, Inc." ("The Report"), generated by L.F. Harris & Associates, CPA, P.A. auditors. While assessing Scholastic, Inc., the auditors came to a number of conclusions. This document is intended to expand upon some of the factual findings and to challenge, where appropriate, some of the auditor's conclusions.

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Thomas M. Naiman, CPA
Director, International Finance
International Division

October 11, 2005

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Luis F. Harris
L.F. Harris & Associates, CPA, P.A.
3012 East Robinson
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Dear Luis,

We have reviewed and discussed the audit report by L.F. Harris & Associates, CPA, P.A. on Scholastic's indirect cost rate proposal for the agreement with the Department of State, Middle East Partnership Agreement. Below, please find our response to the audit's recommendations.

1- Audit recommendation "a general ledger in which direct and indirect costs are separated and accumulated."

Scholastic Inc's general ledger was established as required by the company's policies, businesses needs and to meet it's required reporting for SEC. For the MEPI contract, direct project costs are being tracked, recorded, reviewed and managed. We believe the MEPI project costs are being accurately recorded and tracked.

For identifying direct and indirect costs for the indirect cost pools, these can and have been separated by the general ledger business units. We agree the process can be improved and the Company is in the process of expanding the general ledger business units for department functionality and job responsibilities.

2- Audit recommendation "A payroll system supported by time sheets that clearly identify project and account numbers charged, direct and indirect costs accounts."

In the general course of Scholastic Inc's business, employee's time is not charged directly to specific projects.

For the MEPI project, the International Division's MEPI accountant tracks and maintains records of direct costs being charged to the project, including timesheets submitted by those employee's involved.

Scholastic Inc's company policy is followed, whereby each employee signs in on their departmental time sheet, with non-exempt employees noting any deviation from their



standard work hours. Employee's time is entered into the payroll system by "Cluster Reporters". Sign-in sheets are reviewed by the department Managers and/or Business Manager. Each pay period, Business Managers receive a payroll report from the payroll department. This report details the employee time and salary expense being recorded to that Business Manager's responsible business units in the general ledger.

3- Audit recommendation "A job cost report in which cost directly related to the specific jobs or projects are recorded."

Currently, specific expenses to the MEPI project are tracked in Excel with physical invoices and timesheets maintained as back-up in a binder. Through the Accounts Payable system, we track project invoice payments to the general ledger. While we believe we are adequately recording and tracking the MEPI project costs, we agree that a better and more efficient method should be adopted. A unique general ledger business unit will be set-up for the MEPI project.

4- Audit recommendation "Periodic reconciliation of job cost reports with the general ledger."

MEPI project direct job costs are tracked and reported using Excel. We believe we are adequately recording and tracking the MEPI project costs and track vendor payments through the accounts payable system. We agree that reconciling job cost reports to the general ledger is an important control and this will be done on a monthly basis.

5- Audit recommendation "A Schedule of Indirect Cost should be prepared periodically in accordance with the requirements of OMB Circular A-122."

The indirect cost percentage is a critical component of the MEPI Project regarding reimbursement for general and administrative overhead costs. Our understanding is that a Schedule of Indirect Costs is required by OMB Circular A-122, to be prepared annually.

For the MEPI Project, we will prepare the indirect cost calculations every six months to monitor rates that effect invoicing to the US State Department.

In addressing the Audit recommendations above with the applicable internal procedure adjustments, where noted, we believe this will provide a comprehensive Indirect Cost Allocation Plan.

Regards,

A handwritten signature in black ink, appearing to read "Thomas M. Naiman", written over a horizontal line.

Thomas M. Naiman

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