CORPORATION FOR PUBLIC BROADCASTING
OFFICE OF INSPECTOR GENERAL

AUDIT OF PBS AND CPB GRANTS AWARDED TO THE FRED ROGERS COMPANY FOR THE PRODUCTION OF “PEG+CAT” AND “DANIEL TIGER’S NEIGBORHOOD”

FOR THE PERIOD JULY 1, 2012 THROUGH SEPTEMBER 30, 2015

REPORT NO. APT1604-1704

March 31, 2017

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Office of Inspector General
Corporation for Public Broadcasting

Report No. APT1604-1704
March 31, 2017

Report in Brief

Why We Did This Audit

We performed this examination based on our annual audit plan.

Our objectives were to determine whether the Fred Rogers Company (FRC):
a) financial reports fairly presented total project grant expenditures; b) costs were incurred in accordance with grant requirements; and
c) complied with grant requirements for the period July 1, 2012 through September 30, 2015.

This report contains the views of the Office of Inspector General (OIG). The Corporation for Public Broadcasting (CPB) will make the final decision on our findings and recommendations.

Send all inquiries to our office at (202) 879-9669 or email OIGemail@cpb.org or visit www.cpb.org/oig

Listing of OIG Reports

Audit of PBS and CPB Grants Awarded to The Fred Rogers Company for the Production of "Peg +Cat" and "Daniel Tiger's Neighborhood" for the Period July 1, 2012 through September 30, 2015

What We Found

As a result of our audit, we recommend CPB recover $821,640.

Except for the matters discussed below, the FRC financial reports submitted to CPB fairly present the costs of these productions in conformity with the PBS and CPB grant agreement requirements:

- over recovery of $614,548 in direct production costs for the Peg + Cat production (CPB's portion totaled $363,812);
- questioned Daniel Tiger's Neighborhood pre-term and indirect costs of $312,039;
- understated CPB ancillary revenues of $145,789 for the Peg + Cat production; and
- lack of full compliance with federal requirements for Ready to Learn (RTL) grant activities for the Peg + Cat production.

FRC agreed with our questioned costs finding but disputed the other findings. CPB management will make the final determination on our findings and recommendations.

What We Recommend

That CPB take the following actions to:

- recover $363,812 in overpayments for the Peg + Cat production and amend its current agreement to report all funding sources on financial reports;
- recover $312,039 in questioned costs;
- ensure oversight of grantees reinforces RTL requirements;
- require FRC to provide support for its current indirect cost rate; and
- require FRC to distribute corrected ancillary revenues in the amount of $145,789 to CPB.

Corporation
for Public
Broadcasting

Office of Inspector General

Date: March 31, 2017

To: Jackie J. Livesay, Vice President, Compliance
Debra Sanchez, Senior Vice President, Education & Children's Content Operations

From: Mary Mitchelson, Inspector General Mary Mitchelson

Subject: Audit of PBS and CPB Grants Awarded to The Fred Rogers Company for the Production of "Peg + Cat" and "Daniel Tiger's Neighborhood" for the Period July 1, 2012 through September 30, 2015, Report No. APT1604-1704

Enclosed please find our final report, which contains our findings and recommendations. CPB officials must make a final management decision on the findings and recommendations in accordance with established audit resolution procedures.

We request that you provide us with a draft written response to our findings and recommendations within 90 days of the final report. We will review your proposed actions and provide our feedback before you issue a final management decision to the grantee, which is due within 180 days of the final report. For corrective actions planned but not completed by the response date, please provide specific milestone dates so that we can track the implementation of corrective actions needed to close the audit recommendations.

We will post this report to the Office of Inspector General's website as required by the Inspector General Act of 1978, as amended. Please refer any public inquiries about this report to our website or our office.

Enclosure

cc: Lori Gilbert, Chair, CPB Board of Directors
Bruce M. Ramer, Chair, CPB Audit and Finance Committee
U.S. Senate Committee on Homeland Security and Governmental Affairs
U.S. House of Representatives Committee on Oversight and Government Reform
U.S. Senate Committee on Commerce, Science and Transportation
U.S. House of Representatives Energy and Commerce Committee
U.S. Senate Committee on Appropriations
U.S. Senate Labor-HHS-Education Appropriations Subcommittee
U.S. House of Representatives Committee on Appropriations
U.S. House of Representatives Labor-HHS-Education Appropriations Subcommittee

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EXECUTIVE SUMMARY

We have completed an audit of the Corporation for Public Broadcasting (CPB) grants for the Peg + Cat and Daniel Tiger's Neighborhood productions, including Department of Education Ready to Learn (RTL) pass through grant funds awarded through PBS for the period July 1, 2012 through September 30, 2015. Our objectives were to determine whether: a) financial reports fairly presented total project grant expenditures; b) costs were incurred in accordance with grant requirements; and c) the grantee complied with grant requirements.

Based on our audit, except for the matters discussed below, the financial reports presented in Exhibits A-B fairly present the results of The Fred Rogers Company (FRC), co-venture producer 9 Story, and related entities' activities in conformity with PBS and CPB grant agreement requirements for the period July 1, 2012 through September 30, 2015:

- over recovery of $614,548 of PBS/CPB direct production costs for the Peg + Cat production (CPB's portion totaled $363,812) reported as funds put to better use;
- questioned Daniel Tiger's Neighborhood production costs of $312,039 for noncompliance with CPB grant terms related to pre-term and indirect costs;
- understated CPB ancillary revenues of $145,789 for the Peg + Cat production; and
- lack of full compliance with federal requirements for RTL grant activities for the Peg + Cat production.

We recommend that CPB:

- recover $363,812 of excess CPB funding of the Peg + Cat production;
- amend its current terms and conditions for production agreements to require that grantees report total production project funding on their financial reports to provide complete accountability over the projects' funding sources and expenditures and require reconciliations of the final financial reports to future ancillary revenue (Recoupment and Participation) reports;
- recover $312,039 in questioned CPB costs for the Daniel Tiger's Neighborhood production; and
- periodically monitor PBS's oversight of its large subrecipients to verify that grant recipients comply with RTL requirements for the following: i) project budgets, financial reporting, and accounting records separately identify the use of federal funds; and ii) negotiated subcontracts include access provisions for CPB as required by RTL.

We also recommend that CPB require FRC to:

- correct its final financial report for Daniel Tiger's Neighborhood Season 2 regarding indirect rates before CPB makes its final payment on the grant;
- provide documentation supporting its indirect cost rate on current grants;

- recalculate the Peg + Cat Recoupment and Participation Report in accordance with the grant agreement Exhibit C terms to correct the producer's deficit used in calculating ancillary revenues to be distributed; and
- distribute to CPB corrected ancillary revenues in the amount of $145,789 after any adjustments for over recovery of reported project expenses or other adjustments made in subsequent Recoupment and Participation Reports.

In response to the draft report, FRC management agreed with our questioned costs finding and some components of our finding regarding the ancillary revenue calculations but strongly disagreed that it had over recovered production expenses. FRC also did not agree that it did not fully meet federal requirements, to the extent it was required to. FRC's written response to the draft report is presented in Exhibit G.

We performed this audit based on the Office of Inspector General's (OIG) 2016 annual plan. We conducted our audit in accordance with *Government Auditing Standards* for financial audits. Our scope and methodology is discussed in Exhibit F.

This report presents the conclusions of the OIG and the findings do not necessarily represent CPB's final position on the issues. While we made recommendations we believe would be appropriate to resolve the findings, CPB officials will make final determinations on our findings and recommendations in accordance with established CPB audit resolution procedures.

Based on FRC's response to the draft report, our recommendation on $312,039 in questioned costs is resolved but open pending CPB's final management determination and recovery of the questioned costs. The remaining recommendations are unresolved pending CPB's final management determination.

BACKGROUND

The Corporation for Public Broadcasting (CPB) is authorized by the Communications Act of 1934, as amended, 47 U.S.C. § 396, to award grants to public telecommunications entities; national, regional, and other systems of public telecommunications entities; and independent producers and production entities. Specifically, CPB awards grants to fund projects for broadcast and other uses by public telecommunications and educational systems and had five active grants to The Fred Rogers Company (FRC) during our audit period. In addition, in 2010 CPB received a grant from the Department of Education (DOE) Ready to Learn (RTL) program to fund CPB's Expanded Learning Through Transmedia Content program.[1] CPB subgranted a portion of these RTL funds to PBS, which in turn made subawards to various independent producers, including FRC. Additionally, CPB partially funds PBS's National Program Service (NPS) activities, including awards to FRC.[2] CPB, RTL, and CPB's NPS funding is shown in the table below:

[1] DOE Grant PR/Award Number U295A100025, CFDA No. 84.295A.
[2] CPB by statute awards national television programming grants to PBS, which include the NPS funding for Daniel Tiger's Neighborhood Season 2.

CPB Funds Awarded to FRC

CPB Grant Number	Project	CPB Education Initiative Funds	RTL	CPB NPS	Total CPB and RTL Funding	Total Budget as Amended
PBS/CPB/RTL	Peg + Cat Season 1	$3,000,000	$7,990,845		$10,990,845	$16,801,782
15322	Peg + Cat Season 2	2,250,000			2,250,000	13,029,049
14816	Odd Squad Season 1	3,000,000	7,950,000		10,950,000	18,225,715
15436	Odd Squad Season 2	2,250,000			2,250,000	11,630,303
15059	Daniel Tiger’s Neighborhood Season 2	1,708,772		1,600,000	3,308,772	14,732,918
Total		**$12,208,772**	**$15,940,845**	**$1,600,000**	**$29,749,617**	**$74,419,767**

PBS is a nonprofit organization whose members are America’s public TV stations.
The PBS agreement with FRC states that, “…PBS is responsible for delivering to its public television stations a national program service (the “National Program Service” or the “NPS”) for home and educational use in various media.”

FRC is an independent producer and major supplier of children’s programming for PBS. It is a 501(c)(3) non-profit founded in 1971 to produce the television series Mister Roger’s Neighborhood. Its mission is: “The Fred Rogers Company strives to build on Fred Rogers’ legacy by creating quality children’s media that models an enthusiasm for learning and earns the trust of parents and caregivers.” FRC stated it is proud of its 20 Emmy nominations and 12 wins for the three series along with DOE’s annual Government Performance and Results Act review giving it the highest ratings for its transmedia curriculum execution.

Through its wholly owned subsidiaries, FRC entered into co-venture agreements with Canadian animation and film company 9 Story to produce Peg + Cat and the Daniel Tiger’s Neighborhood series. These agreements provide additional program funding and take advantage of Canadian tax credits. FRC works with a different Canadian animation company to produce the Odd Squad series. We present our audit of Odd Squad Season 1 in a separate report.

This report discusses our audit of the CPB and RTL grant funds paid to FRC, its Canadian co-venture producer 9 Story, and related entities shown in the following table:

CPB and RTL pass through Grants Audited

Grant Number	Project	CPB Education Initiative Funds	CPB NPS	RTL	Total CPB and RTL Funding	Total Budget as Amended
PBS/CPB/RTL	Peg + Cat Season 1	$3,000,000	-	$7,990,845	$10,990,845	$16,801,782
15059	Daniel Tiger's Neighborhood Season 2	1,708,772	1,600,000	-	3,308,772	14,732,918
	Total	**$4,708,772**	**$1,600,000**	**$7,990,845**	**$14,299,617**	**$31,534,700**

The final financial report for Peg + Cat Season 1 and the interim financial report for Daniel Tiger's Neighborhood season 2 are shown on Exhibits A and B.

CPB, PBS, and RTL funded FRC's Peg + Cat Season 1 production through a joint NPS production and distribution agreement dated June 29, 2012 to produce 40 episodes of the series. Peg + Cat is an animated math adventure show for children 3-5 years old. Its creators partnered with FRC and formed Feline Features, LLC to produce the series. Feline Features, LLC formed a co-venture with Canadian producer 9 Story to co-produce and finance the series and negotiated a fixed price Production Services Agreement (PSA) with a wholly owned subsidiary of 9 Story for the animation services. 9 Story had produced program content for PBS in the past and has other current PBS programs in production including Daniel Tiger's Neighborhood.

CPB provided FRC with a supplemental grant to the PBS NPS agreement for Daniel Tiger's Neighborhood Season 2 production. The PBS NPS agreement also included separate CPB NPS funds. Daniel Tiger's Neighborhood is an animated series for children aged 2-4 and builds on the Mister Roger's Neighborhood legacy to engage children in stories about life of a preschooler grounded in social-emotional curriculum. FRC's wholly-owned subsidiary, Striped Tiger, LLC formed a co-venture with Canadian producer 9 Story to co-produce and finance the series and negotiated a fixed price PSA with a wholly owned subsidiary of 9 Story for the animation services.

RESULTS OF AUDIT

In our opinion, except for the matters discussed below, the financial reports presented in Exhibits A-B fairly present the results of FRC, co-venture producer 9 Story, and related entities' activities in conformity with PBS and CPB grant agreement requirements for the period July 1, 2012 through September 30, 2015.

We have audited the accompanying FRC final and interim financial reports expenditures for the PBS/CPB/RTL agreement for the Peg + Cat, Season 1 (Exhibit A) and CPB Grant No. 15059 Daniel Tiger's Neighborhood Season 2 (Exhibit B) for the period ending September 30, 2015. The financial reports are the responsibility of FRC management. Our responsibility is to express an opinion on these reports based on our audit.

We conducted our audit in accordance with *Government Auditing Standards* for financial audits and auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial reports are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial reports to determine compliance with the grant agreement requirements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial reports. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. FRC prepared the accompanying final and interim financial reports to comply with the grant financial reporting requirements.

As discussed in the Findings and Recommendations section of this report, our audit found:

- over recovery of $614,548 of PBS/CPB direct production costs for the Peg + Cat production (CPB's portion totaled $363,812) reported as funds put to better use;
- questioned Daniel Tiger's Neighborhood production costs of $312,039 for noncompliance with CPB grant terms;
- understated CPB ancillary revenues of $145,789 for the Peg + Cat production; and
- lack of full compliance with federal regulations for RTL grant activities for the Peg + Cat production.

In accordance with *Government Auditing Standards*, we considered FRC's internal control over financial reporting and its compliance with provisions of law and grant agreement requirements. The purpose of the following explanations are to describe the scope of our testing of internal control over financial reporting and compliance, and the results of that testing, and not to provide an opinion of the effectiveness of internal control over financial reporting or on compliance. Accordingly, this information is not suitable for any other purpose.

Internal Control over Financial Reporting

In planning and performing our audit of the final and interim financial reports submitted to CPB, we considered FRC's internal control over financial reporting to design audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial reports provided to CPB but not for the purpose of expressing an opinion on the effectiveness of internal control. Accordingly, we do not express an opinion on the effectiveness of FRC's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. Our audit identified significant deficiencies in internal control in financial reporting to prevent the over recovery of PBS/CPB production costs for this project totaling $614,548, discussed further in the findings and recommendations section of the report.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement on the entity's financial reports will not be prevented or detected and corrected on a timely basis. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether FRC's financial reports are free from material misstatements, we performed tests of its compliance with certain provision of law and grant agreement requirements, noncompliance with which could have a direct and material effect on the determination of financial report amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed lack of full compliance under the PBS agreement with federal RTL grant regulations and noncompliance with CPB requirements for Grant Number 15059 resulting in questioned costs of $312,039, discussed further in the Findings and Recommendations section of the report.

FINDINGS AND RECOMMENDATIONS

Over Recovery of Production Expenses (Funds Put to Better Use)

Our audit found that the National Science Foundation (NSF) funded $915,749 in direct production costs for the Peg + Cat Season 1 production, a portion of which PBS/CPB also funded. As a result, FRC recovered $614,548 in PBS/CPB funding in excess of the total production costs incurred for this project. CPB's portion of this duplicate recovery totals $363,812, which we have classified as funds put to better use for reporting purposes.

Our reconciliation of FRC's general ledger detailed transactions to the final financial report submitted to PBS/CPB identified that a NSF grant was used to fund the Peg + Cat Season 1 production. FRC separately accounted for NSF expenses totaling $2,134,113 ($915,749 for direct production, $184,981 for overhead expenses, and $1,033,383 for research expenses) in account code #728. PBS, CPB, and RTL expenses were accounted for in account code #727. FRC included the NSF direct production expenses of $915,749 in the final financial report submitted to PBS/CPB in Exhibit A and as detailed in Exhibit D, resulting in FRC being reimbursed $614,548 by PBS/CPB for those same direct production costs. Therefore, FRC was reimbursed in excess of the total production costs for this project. CPB's portion of this over recovery was $363,812. (See calculation of the producer's surplus of $614,548 on Exhibit C and NSF funded production costs on Exhibit D.)

The PBS/CPB/RTL agreement directed that its funds be used only for direct production costs:

> Producer shall apply the Series Payment toward the production of the Series in accordance with the terms and conditions of this Agreement and Series Payment shall not be reallocated or used for any other use other than as expressly provided herein without prior written approval from PBS, CPB and the DED, as applicable. **CPB, PBS, and/or RTL funds shall only be used to cover direct costs related to the Production of the Series….** (emphasis in original)
>
> 6.2 Producer acknowledges and agrees that all funds provided by PBS to Producer are provided on a cost-reimbursement basis only and that in no event will any portion

of the Series Payment be disbursed or applied by Producer for any purpose other than the Series production hereunder.

Peg + Cat Series 1 Production and Distribution Agreement PBS/CPB/RTL agreement, Section 6. Series Payment, Series Budget and Underwriting Section 6.1.A. and 6.2

FRC did not agree that the NSF funding of the Peg + Cat direct project costs was duplicative of the funding it received from PBS/CPB/RTL, because it considered NSF funds "net underwriting" under the PBS/CPB/RTL grant agreement, Exhibit C – Production and Distribution Agreement Revenues and Royalties. The agreement's Exhibit C defines net underwriting as financial support that shall be applied in full to reduce the series deficit. FRC included the NSF funds in the producer's aggregate receipt of net revenues under Section E, Revenue Participations. (More extensive discussion of the criteria is presented in our finding on ancillary revenues.)

FRC said the NSF net underwriting revenue's use was specific to the Recoupment and Participation report and had no bearing on how project costs were reported to PBS and CPB. FRC said it correctly applied the NSF revenues to the additional recoupment of $3,294,809, an amount that was stipulated in the agreement Exhibit C (shown as Exhibit E in our report).

FRC discretely accounted for the NSF Peg + Cat direct production costs of $915,749 in its general ledger and those costs were reimbursed by NSF. The NSF costs were also included in the total production costs reported on the final financial report submitted to PBS/CPB, resulting in the duplicate reporting of direct production costs. Based on the final report PBS/CPB over-reimbursed FRC $614,548 for total production costs.

The PBS/CPB/RTL agreement did not require FRC to report actual project funding sources on its final financial report. Such accountability would have identified the over reimbursement of production costs by PBS/CPB, as well as facilitate the future processing of FRC's ancillary revenue reports.

Recommendations

We recommend that CPB:

1) recover $363,812 of its excess funding of the Peg + Cat series production from FRC as these same costs were reimbursed with NSF grant funds; and
2) amend its current terms and conditions for production agreements to require that grantees report total production project funding on their financial reports to provide complete accountability over the projects' funding sources and expenditures and require reconciliations of the final financial reports to future ancillary revenue (Recoupment and Participation) reports.

FRC Response

FRC disagreed with our conclusion that it was reimbursed in excess of total direct production costs and affirmed "that all RTL, PBS and CPB funds received were solely used to fund the direct costs of production." FRC stated that the complex agreement contains inherent contradictions regarding uses of funds provided on a cost reimbursement basis and the agreement's Exhibit D payment schedule. It also disagreed that it was paid excess production costs. We discuss FRC's positions more fully below. We present its arguments regarding NSF net underwriting, Canadian funding, and reconciliation under our finding on ancillary revenue distribution understatement.

Reimbursement

FRC addressed what it says are contradictions in the agreement's cost reimbursement terminology that counter OIG's argument that both PBS and CPB funds were awarded on a cost reimbursement basis. FRC argued that if it was truly a cost reimbursement agreement the agreement would specify how the PBS/CPB/RTL funds were to be spent (eligible and not eligible costs). There would also need to be a mechanism for payment when costs had been incurred. FRC stated that the agreement does not separately specify how the RTL, PBS, and CPB funds must be used and described the essence of this funding as fungible, amounting to 77 percent of the total budget. FRC said payments to it were based on production deliverables that were not dependent on cost reimbursement.

FRC argued that the payment schedule is binding on PBS/CPB once the delivery has been made, regardless of the cost incurred, and that such a payment provision is incompatible with payments on a purely cost reimbursement basis. FRC also asserted that Section 6.2, concerning deobligation has no purpose if funds were provided on a true cost reimbursement basis. FRC concluded that the payment schedule, Exhibit D, was precedent and binding on all parties and negated any cost reimbursement provision. FRC noted that PBS apparently shared that interpretation because PBS paid FRC pursuant to Exhibit D.

In Excess of Total Production Costs

FRC also disagreed that PBS/CPB/RTL funding was paid in excess of total productions costs. FRC said the agreement with PBS, CPB, and RTL provided funding of $12,500,000 for reported project costs of $16,286,075 of which $13.2 million was recorded on its books, excluding the Canadian costs and funding, therefore showing that there was no excess funding. It further stated that even if you included the actual funding received at the time the final financial report was submitted (including the NFS cost reimbursement funding), the total funding would still not be in excess of total costs. ($11,915,709 received from PBS/CPB/ RTL plus $1,069,142 from NSF that total $12,984,851 is still less than the $13.2 million in costs on its books.)

OIG Review and Comment

Based on FRC's response we have not changed our findings and recommendations. We consider recommendation one unresolved pending CPB management's final determination. Regarding recommendation two, we agree with FRC's response that these agreements and reporting issues are complex. Simplifying terminology and understanding of requirements would benefit all parties and ensure consistency for such complex arrangements. We consider recommendation two unresolved pending CPB management's final determination. As discussed below, this is a cost reimbursement agreement and FRC was overpaid by PBS/CPB in the amount of $614,548.

Reimbursement

We disagree that FRC is entitled to the payments as scheduled in the PBS/CPB/RTL agreement Exhibit D – Program Payment Schedule whether it incurred costs or not. Section 6.1A and 6.2 clearly define the agreement as a cost reimbursement contract. Exhibit D of the agreement provides the time table and deliverables for receiving payments. This payment schedule does not make FRC entitled to payments if it has not incurred the underlying costs. Exhibit D contained a footnote on CPB's payment schedule column, which stated "$3,000,000 from CPB will be paid directly by CPB to Producer with final payment subject to 6.2." Section 6.2 of the agreement stated, "Producer acknowledges and agrees that all funds provided by PBS to Producer are provided on a cost-reimbursement basis only …"

FRC also argued that if this was a true "cost reimbursement agreement" the deobligation provisions of Section 6.2 would not be necessary. (FRC also noted that PBS did not deobligate any of its funds, while CPB did.) We disagree. Section 6.2 establishes the cost reimbursement terms of the agreement; the deobligation provision of Section 6.2 merely provides the funder with latitude to decide not to reduce its funding if actual final costs are less than budgeted.

In Excess of Total Production Costs

We do not agree with FRC's position that it experienced a production deficit. Its calculation was based on cash reimbursements received through September 30, 2015 and did not consider the funds due from PBS and CPB of approximately $980,409 that was subsequently paid to FRC. We agree that the total project cost reported was $16,286,075. However, as our report's Exhibit D demonstrates, PBS/CPB/RTL reimbursed FRC $12,896,118, NSF paid $915,749 in direct production costs, and the Canadian partner will contribute $3,088,756 to the project. These fund sources totaled $16,900,623, resulting in an excess reimbursement of $614,548 by PBS and CPB.

To avoid duplicate payment, FRC must subtract the $915,749 in direct production costs (per report's Exhibit D) that it claimed from both NSF and PBS/CPB/RTL, leaving a balance of $15,370,325 to be paid by PBS/CPB/RTL and FRC's Canadian partner. After adjusting this balance by the Canadian tax credit of $3,088,756, $12,281,570 remains to be paid by PBS/CPB/RTL. FRC was reimbursed a total of $12,896,118 from PBS/CPB/RTL, which resulted in an over-payment of $614,548 for this production; CPB's portion is $363,812.

Questioned Production Costs

Our audit of CPB funds found questioned CPB costs of $312,039 under the Daniel Tiger's Neighborhood, Season 2 project, for pre-term and excess indirect costs per the following table.

Questioned CPB Costs

Noncompliance	Daniel Tiger's Neighborhood CPB Grant No. 15059	Total CPB Questioned Costs
Pre-term costs	$243,647	$243,647
Excess indirect	68,392	68,392
Total Questioned	**$312,039**	**$312,039**
Total Reported	**$13,979,562**	

The timing of the grant expenditures and incorrect indirect rate calculations that contributed to these questioned costs are discussed further below**.**

Pre-Term Costs

FRC reported costs of $243,647 that were incurred prior to the June 1, 2014 start date for CPB grant No. 15059, Daniel Tiger's Neighborhood Season 2. We questioned these costs, which were 100 percent funded by the CPB grant. See Exhibit B.

CPB's grant clearly stated the term for incurring grant costs and its general terms established how grant funds could be applied to the project.

> Article 4.Term. The term during which costs may be incurred pursuant to the Budget shall be from **June 1, 2014** through **March 31, 2016**.

CPB's Production Agreement for "Daniel Tiger's Neighborhood Season 2" CPB grant No. 15059.

CPB also required the grantee to repay any misapplied funds.

> F. Authorized Uses of CPB Funds. No Grantee may apply amounts received under a Grant to any purpose other than actual costs incurred in performance of the Grant Project in accordance with its Budget… Grantee agrees to repay to CPB, immediately upon CPB's written request, any portion of the Grant which CPB determines has been expended in a manner that is inconsistent with either these Terms and Conditions or the individual Grant Agreement….

CPB Terms and Conditions for Television, Radio and other Media Production Grants, Section 4. Budget and Financial Reporting.

FRC began production on Daniel Tiger's Neighborhood Season 2 and entered into a production and distribution agreement with PBS for the series on October 1, 2013, prior to the CPB grant being awarded. The CPB grant supplemented the PBS budget, added additional CPB specific budget line items, and had a term of June 1, 2014 through March 31, 2016. The questioned costs related to CPB specific budget line items and not the PBS budgeted line items.

FRC said it was aware of the effective date for incurring costs for the CPB specific budget line items and that the costs incurred were actual costs of the project, because production and related activities had commenced prior to the CPB award. Correspondence between FRC and CPB showed the parties were in agreement about the grant start date. Further, subsequent to our audit period, FRC submitted a final financial report that showed variances in some of the questioned costs budget line items. FRC's variance explanations did not address the fact that some of the costs had been incurred prior to the CPB grant award, however.

Because FRC reported costs incurred prior to June 1, 2014 for CPB grant specific budget line items, CPB over reimbursed direct and indirect costs totaling $243,647 as summarized in the following table and detail provided in Exhibit B.

Pre-Term Questioned Costs

Daniel Tiger's Neighborhood Season 2 Grant No. 15059	Questioned Pre-term Costs
CPB Budget Specific Costs incurred prior to 6/1/2014	$203,498
Indirect costs on pre-term direct costs	$40,149
Total Pre-term Costs	*$243,647*
% CPB funding	100%
Questioned Costs	**$243,647**

Excess Indirect Costs

We identified an additional $68,392 in excess indirect costs reported by FRC on CPB budget line items for CPB's Daniel Tiger's Neighborhood Season 2 project. FRC had negotiated a 25 percent indirect cost rate with CPB for this production based on its fiscal year (FY) 2013 financial records. However, the actual rates, per FRC's financial records, were much lower: 18.1 percent in FY 2013; 9.6 percent in FY 2014; and 10.5 percent in FY 2015. By applying FRC's actual indirect cost rates, we identified $68,392 in excess indirect costs, as shown in the following chart. We also discuss the impact of using the actual indirect cost rate on the reporting of PBS costs under *Other Matters – Indirect Costs Reported to PBS.*

Excess Indirect Cost CPB Grant No. 15059

Description	Amounts
Indirect costs reported to CPB thru 6/30/15	$161,270
Less: Indirect on questioned pre-term costs	40,149
Less: Indirect on App eliminated from project	6,250
Adjusted Indirect costs	**$114,871**
Direct cost base used to calculate indirect costs	$459,484
FY 2015 rate 10.5% (FY 15 portion of base 57.3%)	27,644
FY 2014 rate 9.6% (FY 14 portion of base 42.7%)	18,835
Allowable Indirect Costs	**$46,479**
Questioned CPB Indirect Costs	***$68,392***

CPB's grant to FRC incorporated CPB's terms and conditions and indirect cost policy.

> This Grant Agreement is made pursuant to (i) CPB's Terms and Conditions for Television, Radio and Other Media Production Grants (April 2013) (the "Terms and Conditions"), a copy of which is available at www.cpb.org/grants/termsandconditions and is incorporated by reference thereto and (ii) the CPB Guidelines for Indirect Costs (FY 2014), a copy of which is available at http://www.cpb.org/grants/indirectcosts.

CPB's Production Agreement for Daniel Tiger's Neighborhood Season 2 CPB grant No. 15059. Background section.

CPB's indirect cost guidelines permit alternative approaches, none of which FRC applied properly.

> Recovery of indirect costs from CPB is not an entitlement. As part of the grant proposal and review process, CPB and prospective recipients may agree on a budget line for indirect costs in a grant agreement. If CPB agrees to support indirect costs in a particular grant, the amount of those costs charged against a grant is limited to the amount specified in the agreement. These must be the organization's actual indirect costs and the amount charged must be supported by solid accounting practices. Specific costs may not be included in both the direct costs of a project and the indirect cost pool. Grantees must employ methodologies that result in costs being paid by CPB only once.
>
> These Guidelines are intended to provide prospective recipients of CPB funding with methods for calculating indirect cost. Each cost that is included in the indirect rate calculations must have a general nexus to the overall support of the grant activities funded.
>
> Regardless of the methodology and calculation used, CPB grants are made on a cost reimbursement basis for costs that have been budgeted and actually incurred. All costs, including indirect cost calculations, must be supported with auditable documentation. The inclusion of an amount in a grant agreement for indirect costs does not mean that a grantee is entitled to charge that amount to the grant. The grant recipient may only charge its actual indirect expenses up to the amount included in the budget line (except as provided under Method 1.) …
>
> <u>Method 1. Use the organization's Federal Indirect Cost Rate in accordance with OMB Circular A-122</u>
>
> Regardless of the cognizant agency, this Federal Indirect Cost Rate ("FICR") must be the current active rate (whether provisional or final) applied by that agency as of the time of the Agreement is executed. Documentation of the approved FICR will be required…
>
> <u>Method 3. Use the CPB Treatment to calculate an indirect cost rate ("CPB Rate")</u>
>
> **…** c. The CPB Rate in effect at the time that the Agreement is signed applied for the full term of the agreement, provided that the grantee's actual costs have not decreased. If the CPB Rate decreases during the term of the Agreement, the grantee may only be reimbursed for the lower amount of its actual costs…

CPB Guidelines for Indirect Costs **–** *Updated March 24, 2014*

FRC said it has been using the 20.2 percent federal expired indirect rate, which dates back to approximately 1999. FRC provided support to show that several federal entities had accepted the rate in their grant agreements, but FRC had no support for the calculation of the rate or current federal approval of it. During grant negotiations CPB did not accept the expired federal rate pursuant to CPB policy and asked FRC to provide an indirect rate pursuant to CPB's indirect cost guidelines.

Using the CPB guidelines, FRC prepared a 36 percent indirect rate based on its most recent FY 2013 audited financial statement expenses. CPB thought that the rate was too high and negotiated it to 25 percent. We found the 25 percent rate was over-stated because it included amortization of capitalized production costs for work in process and resulted in double counting the direct production costs included in the direct cost base. Further, FRC's rate calculation did not include a material reclassification from an indirect cost center to a direct cost center for capitalized film amortization expenses, which were originally classified in the indirect cost pool as depreciation. This omission materially distorted the indirect cost pool and therefore the indirect cost rate.

We discussed this calculation and methodology error with FRC, and it provided us with a revised FY 2013 indirect rate of 18.1 percent using the proper allocation methodology. We also requested the rates for FY 2014 and FY 2015 to determine if the rates had decreased, as these were the FYs that the project incurred costs. The rates decreased to 9.6 percent for FY 2014 and 10.5 percent in FY 2015. We applied these actual rates to the project costs reported based on a percentage of costs incurred in each year. We also excluded the indirect costs of $40,149. that were included in the questioned pre-term costs discussed in the previous section.

FRC said it was not fully aware of CPB's indirect cost guidelines requirement that negotiated rates needed to be assessed annually based on actual indirect costs and reported out based on its negotiated rate in the agreement. We questioned CPB line item costs totaling $68,392 for excess indirect costs because FRC's actual indirect costs and rate were less than its negotiated rate and indirect costs reported.

Other Matters – Indirect Costs Reported to PBS

As an additional matter, we also found that FRC applied an expired federal indirect rate of 20.2 percent to the approved PBS budget, which included CPB NPS grant funds of $1.6 million. We estimated that the PBS agreement was over charged approximately $992,547 for indirect costs based on the difference between the expired federal indirect rate and the actual audited indirect cost rate. Actual indirect cost rate ranged from 18.1 percent to 9.6 percent of direct costs over the three-year life of the project, as discussed further below.

The methodology PBS approved in the budget and FRC used to claim indirect costs did not follow either the federal OMB Circular A-122 regulations or CPB's indirect cost policy. If CPB had required NPS funds to follow CPB's indirect cost policy, we estimate CPB's share of over-reported indirect costs on CPB's NPS funds would have resulted in additional questioned CPB indirect costs of $119,106 over the $68,392 questioned in our previous discussion.

Under the PBS agreement FRC also claimed indirect costs on approximately $7.3 million of FRC's co-venture producer's (9 Story) costs. Over $2.5 million of those reported funds were not even recorded on FRC's books. OMB Circular A-122 limits the amount of indirect costs that can be claimed on third party direct costs to $25,000 per agreement, which is similar to CPB's indirect policy. We did not quantify the amount of additional indirect costs claimed by including 9 Story's total direct costs in the base FRC used to calculate indirect costs under the PBS agreement. However, applying the actual indirect cost rates to FRC's booked costs and limiting the amount of third party costs to only $25,000 (instead of $7.3 million) in the base used to claim indirect costs would reduce total project costs and affect the subsequent calculation of ancillary revenue distributions to both PBS and CPB.

Recommendations

We recommend that CPB:

3) recover $312,039 in questioned costs ($243,647 pre-term and $68,392 excess indirect) funded for Daniel Tiger's Neighborhood season 2 grant;
4) ensure FRC's final financial report reflects the correct indirect rates before making its final payment on the grant; and
5) require FRC to provide documentation supporting its indirect cost rate on current CPB grants.

FRC Response

FRC agreed with the questioned pre-term ($243,647) and excess indirect ($68,392) costs. FRC re-emphasized that the pre-term costs were incurred in the production of the series, however, due to the timing of the production schedule and later execution of the CPB grant agreement, these costs had been incurred before the designated CPB grant start date.

Regarding the excess indirect costs, FRC deferred to our interpretation and agreed with this finding. It further stated that these costs were charged to the CPB grant based on the CPB negotiated rate, and therefore it was complying with the agreement terms. FRC commented that in future agreements with CPB, it would consider forgoing indirect costs due to the complexity of the rate calculations and annual updates required.

OIG Review and Comment

While FRC agreed with our findings on questioned production costs, its response did not address recommendations three through five: a) repaying questioned costs, b) ensuring its final financial report reflects the correct indirect costs, and c) providing CPB with documentation supporting its indirect cost rate on current CPB grants. As a result, we consider recommendation three resolved, but open pending CPB's final management decision and recovery of questioned costs. Recommendations four and five remain unresolved pending CPB's final management decision.

Ancillary Revenues Distribution Understated (Funds Put to Better Use)

FRC understated its ancillary revenue distribution payable to CPB and PBS due to its interpretation of the PBS grant agreement's Exhibit C, Production and Distribution Agreement Revenue & Royalties, and the incorrect calculation of its producer's deficit for recoupment. Specifically, we found that FRC's September 30, 2015 Recoupment and Participation

Calculation report on Peg + Cat Season 1 (Exhibit E) understated the ancillary revenues to be distributed. FRC's report included a producer deficit based on budgeted amounts not actual expenses and funding sources calculated using both budget estimates and actual amounts. In addition, the currency exchange rate applied to project costs in the final financial reports submitted to PBS/CPB was different from the rate used to convert the project funding sources reported to PBS/CPB on the Recoupment and Participation Calculation report.

While FRC calculated the ancillary revenues as $54,941, OIG calculated them as $864,882. CPB's share is 18 percent, totaling $155,679 and resulting in a $145,789 understated distribution payment due to CPB. PBS's share is $492,983, an understated distribution of $461,666.

Separate from the FRC's calculation of ancillary revenues, FRC's Recoupment and Participation Calculation report also identified its "Additional Producer Recoupment" permitted under the PBS agreement's Exhibit C. There we found that NSF funds of $1,069,142 were applied against the $3,294,809[3] additional producer recoupment amount in the agreement, when $915,749 of those NSF funds were actually spent on direct production expenses, as we previously discussed in the first finding. As a result, the $915,749 spent on direct production costs are not available to be applied against the additional recoupment amount.

Calculation of Producer Surplus

To audit the accuracy of FRC's reported ancillary revenues to be distributed to PBS and CPB, we first had to calculate the initial producer deficit or surplus, which was not specifically identified on FRC's Recoupment and Participation Calculation report. We used the information reported on FRC's Recoupment and Participation Calculation report (Exhibit E) to calculate a producer surplus of $614,548 (versus a deficit of $908,175) that FRC used to end up with its reported net ancillary revenues of $54,941[4]. The following chart shows our calculation of FRC's producer deficit of ($908,175) versus the OIG calculation of a producer surplus of $614,548. We found that FRC's Exhibit E report was based on a mixture of budget estimates and actual amounts. The OIG calculated column was based on actual revenues and costs and FRC's reconciling amount of $3,088,756 representing its Canadian co-venture producer's costs. The latter figure is the difference between FRC's books and the final financial report submitted to PBS/CPB.

[3] We note that the negotiated $3,294,809 amount was based on a calculation of FRC's unfunded overhead costs (20.2 percent of original total budget of $16.3 million). Based on our audit, FRC's unfunded overhead costs were estimated at only $2,239,264. The 20.2 percent rate was excessive and not supported in FRC's records. The rate was applied to a base that included $3.9 million in Canadian budgeted costs not on FRC's books.
[4] This amount is shown as a Surplus on Exhibit E and the amount to be distributed.

OIG Calculation of Producer Surplus

	FRC Reported[5]	OIG Actual[6]	Difference	Comments
Producer Surplus/(Deficit) Calculation:				
Sources of Funding:				
PBS	$2,140,709	$2,000,000	$140,709	
RTL	$7,500,000	$7,990,845	($490,845)	
CPB	$2,905,273	$2,905,273	$0	
NSF	$0	$915,749	($915,749)	FRC's report treated NSF as an underwriter not a direct funder (included only NSF direct production funds in this calculation)
Sub-total	*$12,545,982*	*$13,811,867*	*($1,265,885)*	
Co-Venture Partner Funding:				
YTV	$378,600			
Federal Credits	$426,076			
Provincial Credits	$1,624,913			
Distribution Advance	$567,900			
Sub-total	*$2,997,489*	*$3,088,756*	*($91,267)*	FRC reported co-venture funding based on an average currency conversion rate lower than the fixed rate used to report project's costs / $3,088,756 is FRC's reconciling amount of 9 Story's unrecorded costs
Total Funding	***$15,543,471***	***$16,900,623***	*($1,357,152)*	
Less: Expense Budget - thru Amendment 2	$16,451,646	$16,286,075	$165,571	FRC's report did not include amendment 3 budget / OIG actual amendment 3 expenses
Producer Surplus/(Deficit)	***($908,175)***	***$614,548***	***($1,522,723)***	

The most significant difference between FRC's and our calculation is in the treatment of the NSF funding. Since NSF awarded a direct grant to FRC to fund this project, we considered this grant a primary source of funding that should have been used to calculate the producer deficit. As previously discussed, FRC considered NSF an underwriter under Exhibit C of the PBS/CPB/RTL agreement so that the NSF funds were to be applied after the calculation of the initial producer deficit. We did not agree with FRC's treatment of the NSF funding because the production expenses related to the NSF funding were included in the final financial report submitted to PBS/CPB in Exhibit A and detailed in Exhibit D.

Finally, we noted that the recoupment report showed the funding sources from the Canadian Tax Credits and fees at the contracted amount in Canadian dollars (CDN $3,166,920) converted at an average rate throughout the production period for US dollars (US $2,997,489). However, for project cost reporting, FRC locked in a rate for the costs funded with these credits and fees at US $3,114,054. The average rate reduced the funding source in the amount of $116,565, therefore increasing the producer deficit. To further complicate the matter, FRC's reconciled project cost reporting showed the costs funded with the Canadian sources were $3,088,756, as FRC took into account the loss of $25,298 it absorbed on currency exchanges when making payments to its Canadian co-producer for a net difference of $91,267 as displayed above.

The $915,749 misapplied NSF funds coupled with the differences between budgeted revenues and expenses and actuals used in the OIG calculation accounted for the under reported ancillary revenues of $809,941, of which $145,789 is due to CPB. See table in the next section, *OIG*

[5] As Reported by FRC on its September 30, 2015 Participation and Recoupment Report with OIG added subtotals. (See Exhibit E.)
[6] Per actual final financial report and general ledger detail support. (See also Exhibits A and C.)

Calculation of Ancillary Revenues.

The PBS/CPB/RTL agreement Exhibit C defined what a producer deficit is and what funding can apply to it for recoupment before ancillary revenues are to be shared.

> A.8. **"Production Deficit"** means the difference between the total amount of the funding secured to cover the direct production costs of the Series and the total production costs of the Series as set forth in the Series Budget attached as Exhibit B to the agreement…The parties hereto agree that one hundred percent (100%) of the actual funding projected shall be applied to reduce the Production Deficit on a dollar-for-dollar basis….
>
> E.1. (a) - Deficit Recoupment/Underwriting
>
> Producer may retain one hundred percent (100%) of Projected Funding Net Corporate Underwriting, Foundation Grants and Funding ("Net Underwriting"), and net Revenue until Producer has recouped the Production Deficit in full (including interest charges as noted in the definition of Production Deficit in Paragraph A.8, above).
>
> (b) – Underwriting – once Producer has recouped the Production Deficit in full from all sources Producer may retain one hundred percent (100%) of any additional Net Underwriting until Producer has received a total of three million two hundred ninety four thousand eight hundred dollars and nine dollars ($3,294,809) in excess of the Production Deficit from all sources.

Peg + Cat Season 1 Production and Distribution Agreement PBS/CPB/RTL agreement Exhibit C, Revenues and Royalties, Sections A.8 and E.1.a-b.

Calculation of Ancillary Revenues to be Distributed

We compared what FRC reported on its September 30, 2015 Recoupment and Participation Calculation report, which was based on a production deficit of ($908,175), to our OIG calculation with no deficit. As the following table illustrates, we found that FRC's report was understated by $809,941 due to FRC's methodology for calculating the producer deficit. FRC report was based on a ($908,175) producer deficit[7] versus the OIG calculation of a $614,548 surplus as presented in the previous table. Then we calculated ancillary revenues without a producer deficit or surplus, we identified CPB's share of ancillary revenues of $155,679, as shown in the following table.

[7] FRC reported $15,543,471 in funds from PBS/CPB/RTL and Canadian Co-Partners less project budget $16,451,646 for a deficit of $908,175.

OIG Calculation of Ancillary Revenues

	FRC Reported	OIG Audit of Actual	Difference
Net Revenue Calculation:			
Gross Revenue	$1,106,779	$1,106,779	$0
Distribution Expense	($241,897)	($241,897)	$0
Interest Expense[8]	$98,233		$98,233
Net Revenue	***$963,115***	***$864,882***	***$98,223***
Calculation of Revenue Distribution:			
Net Revenue	$963,115	$864,882	$98,233
Producer Deficit	($908,175)	$0	($908,175)
Revenues to be Distributed	***$54,941***	***$864,882***	***($809,941)***
PBS Share per Exhibit C 57%	$31,316	$492,983	($461,666)
CPB Share per Exhibit C 18%	$9,889	$155,679	($145,789)

The complex nature of the revenues and royalties distribution agreement significantly contributed to the understatement of the ancillary revenues to be distributed, particularly with regard to the interpretation of Section E.1., Deficit Recoupment/Underwriting. Both the treatment of NSF direct production costs and the method of calculating the producer's deficit affected the amount ancillary revenues to be distributed.

FRC reported project funding (revenues) and costs on a hybrid of both budgeted and actual project costs and funding sources. It reported budgeted project costs and PBS/CPB/RTL funding sources (although PBS and RTL amounts were inaccurate) through the agreement amendment 2. In contrast, it reported the actual costs on in its final financial report through amendment 3 of the production agreement. Further, while FRC management stated "… in our view, the cost report's main function is to support the recoupment and participation calculation…", in preparing its recoupment report, FRC used budgeted amounts instead of the actual costs as reported on its final financial report. Both CPB and PBS officials stated that Exhibit C required that actual project costs and funding sources be reported for calculating the producer deficit/surplus.

Revenues to be distributed should have consisted of all the ancillary revenues booked less only the distribution expenses, and by properly including the NSF funds there was no producer deficit. As a result, CPB's ancillary revenues were understated by $145,789, reported as funds put to better use.

Recommendation

We recommend that CPB require FRC to:

6) recalculate its Peg + Cat Recoupment and Participation Report in accordance with the grant agreement Exhibit C terms to correct the producer's deficit by:

[8] FRC included interest expense as an additional source of funding in its calculation. We eliminated it in the OIG calculation because the only known deficit applied to the Canadian producer's costs, which were covered by the fixed price PSA contract and any related financing costs were never booked on the FRC general ledger.

a) using actual project funding committed to date and costs as reported on the final financial report (FRC and 9 Story); and
b) applying the same conversion rate for Canadian dollars used to report its final costs submitted to PBS as the agreement dictated; and

7) distribute to CPB the additional $145,789 in ancillary revenues after any adjustments for over recovery of reported project expenses or other adjustments made in subsequent Recoupment and Participation Reports

FRC Response

FRC agreed with some of our findings on the following: interest expense; OIG's calculation of the producer surplus; and the exchange rates related to the ancillary revenue reporting and distribution (Recoupment and Participation Report, Exhibit E). FRC stated, based on our findings, that it had made adjustments in its Recoupment and Participation Report for a subsequent reporting period. However, FRC disagreed with the other findings on OIG's treatment of the NSF funding in calculating distribution amounts, as well as the $3.2 million additional recoupment amount negotiated in the agreement. FRC's comments are summarized below. We have combined some of FRC's responses to align them more appropriately with our finding. FRC's full written response is presented in Exhibit G.

Producer Deficit or Surplus

FRC did not agree with OIG's method for calculating the producer deficit or surplus, which were based on actual final financial costs reported on the production. FRC said it simply followed the provision of the agreement Exhibit C, A.8 and interpreted it to mean calculating the difference between the funding secured and the budget set forth for the series production and not the actual costs incurred. FRC did acknowledge that the OIG calculation method, using the actual final costs, is more equitable and customary in the industry. Thus, while it asserted OIG's method was not supported by the agreement language, FRC said it had adjusted the calculation for the initial deficit on subsequent Recoupment and Participation Reports in line with OIG's method.

Interest Expense

FRC agreed that it should not have shown interest expense as a source of funding on the participation report and had done so by mistake. Instead, it asserted that it is entitled to interest on a production deficit on a quarterly basis, at a rate stipulated in the agreement, as applied to the negative cash flows throughout the production.

OIG Calculation of Producer Surplus, Canadian Funding Sources, and Reconciliation

FRC agreed with the OIG table showing the sources and amounts of funding received from PBS and RTL. FRC said that it made these corrections on subsequent reports. FRC said the amounts it initially reported did not include the third amendment to the agreement.

FRC agreed with OIG that it had used difference exchange rates for reporting Canadian funding on its final cost report and participation report and stated it was open to discussion on a reasonable solution. FRC also discussed that it is not possible to reconcile all of the production costs reported on its costs reports to PBS and CPB to its books, because the costs incurred by the Canadian producer over FRC's fixed price payment are on the Canadian company's books, not FRC's.

OIG Footnote #4 Additional Recoupment Negotiated Amount (now Footnote #3)

FRC disagreed with OIG's characterization of the negotiated additional recoupment amount of $3,294,809 as based on indirect costs or a producer fee. FRC said it was a contractually negotiated amount that the producer was entitled to recover from certain revenue streams.

Additional Producer Recoupment and NSF Net Underwriting

FRC disagreed with OIG's conclusion that the $915,749 in NSF funding cannot be applied against the $3,294,809 negotiated "additional producer recoupment" because they were already used to pay a portion of the total production costs. FRC explained how it calculated the participation report as required by Exhibit C of the agreement and its tracking of the two separate revenues types, one for back-end share with PBS and CPB and one for the recoupment of the producer's $3,294,809. FRC reasserted that it properly applied the NSF funding to the additional $3,294,809 recoupment.

FRC argued that "whether any of these revenues have been used to fund the production at any previous time (and many have) is entirely irrelevant. Exhibit C concerns itself solely with the *origin and nature* of the revenue stream and contains no qualifications concerning the *purpose* for which the revenue may have previously been used (if any)." FRC responded further to this issue in the finding on over recovery of production expenses.

FRC stated that OIG did not accurately reflect discussions between OIG and FRC concerning FRC's application of the NSF funds as net underwriting in accordance with Exhibit C, Section 6 provisions. FRC asserted that NSF funds can *only* be classified as net underwriting. It further clarified its position that FRC could change the application of net underwriting and all other sources of revenues for participation accounting purposes and not, as OIG stated, that FRC changed the application of the funds between expense categories as cash flows warranted.

FRC explained that initially net underwriting was applied to the producer deficit. However, later in the reporting cycle as new royalties were sufficient to eliminate the deficit and pay participation fees, FRC was able to reclassify the net underwriting to support the recoupment of the $3,294,809. Further, the funds FRC retained went to supporting season two of the series.

FRC said that as of its response date, it had recouped the direct cost deficit and paid ancillary revenues of approximately $974,000 to PBS and CPB. Further, FRC had recouped $1,939,142 of the permitted $3,294,809.

OIG Review and Comments

Based on FRC's response, we have not changed our finding and recommendations. We consider recommendations six and seven unresolved pending CPB's final management decision.

OIG Calculation of Producer Surplus, Canadian Funding Sources, and Reconciliation

FRC acknowledged that it had made some corrections on its subsequent filings of its Recoupment and Participation reports. Since we have not seen or audited the subsequent Recoupment and Participation reports, we cannot attest to whether FRC's corrections included the $606,974 in OIG adjustments FRC said it addressed. These corrections would have included: a) the actual PBS and RTL funds received differences of $350,136; b) actual total expenses difference of $165,571; and c) the exchange rate difference of $91,267. Further, we do not know how our recommended recovery of additional ancillary revenues of $145,791 to CPB was addressed in FRC's subsequent reports. FRC acknowledged the complexity of reporting the currency conversion exchange rates and was open to discussion on how best to report such costs. Further FRC did not address the fact these exchange rates were calculated on funding and costs that were not on FRC's books.

Interest Expense

FRC acknowledged that it had mistakenly included interest on its producer's deficit as a source of funding and stated it is entitled to interest based on negative cash flows throughout the production. We agree the agreement allows for interest charges on the unrecouped production deficit, but based on our calculations, there was a production surplus after excluding the costs and funding from the Canadian sources. As a result, we have not changed our finding and excluded the interest from our calculation for ancillary revenues.

OIG Footnote #4 Additional Recoupment Negotiated Amount (now Footnote #3)

While FRC disagreed with our characterization of the $3,294,809 as recoupment for unfunded overhead costs, FRC's response did not explain what the basis for this recoupment was or why FRC was entitled to these additional recoveries. We included this footnote based upon CPB project files that noted that this amount was negotiated to allow FRC to recover its unfunded overhead costs.

Additional Producer Recoupment and NSF Net Underwriting

We do not agree with FRC's response that the NSF funds were properly applied on its Recoupment and Participation Report towards the additional recoupment of $3.294,809 because, as previously stated, these NSF funds were discretely accounted for and used to reimburse direct production costs. These same production costs were included in the Peg + Cat final financial report and reimbursed by PBS/CPB/RTL, resulting in the over recovery of production costs in our first finding

FRC's argument that the NSF funding could be considered net underwriting for participation accounting purposes does not negate the fact that FRC had already used the $915,749 in NSF funds to pay direct project costs. The NSF funding should have been included when calculating the producer's deficit/surplus.

Federal Award Compliance

Our audit found that while the PBS/CPB/RTL grant to FRC for the Peg + Cat project included all the federal requirements, FRC did not fully comply with specific federal provisions. FRC, as a RTL subrecipient for the Peg + Cat production, did not fully comply with the established DOE Education Department General and Administrative Regulation (EDGAR) and federal requirements (OMB Circular A-110), even though the PBS/CPB/RTL agreements clearly highlighted those provisions. We found that FRC had: 1) not adequately tracked disbursements by projects that specifically identify the federal expenditures related to federal RTL funds; and 2) awarded a negotiated fixed price contract without federal access provisions, as required by EDGAR and OMB Circular A-110. In this regard we found:

- FRC co-mingled RTL with PBS/CPB expenses within its project accounting records, and as a result did not comply with EDGAR and OMB regulations to adequately account for the source and application of federal RTL funds; and
- FRC did not comply with federal procurement regulations in awarding its negotiated fixed price PSA contract to 9 Story.

Discrete accounting for federal funds

We found that FRC was not consistent in how it accounted for federal RTL and NSF funded expenses on the same project; it treated the federal expenditures differently for accounting purposes. We found FRC comingled RTL, CPB, and PBS funded expenses on a detailed line item project basis for the Peg + Cat, Season 1 project (account code #727). In contrast, it discretely accounted for the NSF federal funds within the Peg + Cat, Season 1 project accounting in account code #728. FRC did separately identify RTL revenues in a comingled general ledger account for revenues. For accounting purposes, FRC capitalized its RTL expenditures under the FASB 926 accounting rule for film production but expensed its NSF federal funding in accordance with Not-for-Profit accounting guidance and consistent with other FRC grants, where grant costs are expensed and should agree to revenues recognized. FRC did report a portion of the total capitalized costs incurred against the RTL revenues reported for its federal A-133 audit and schedule of federal expenditures.

RTL regulations state that the grantee must maintain:

> (b)(2) Records that identify adequately the source and application of funds for federally-sponsored activities.

EDGAR Title 34 CFR Subtitle A Part 74-Administration of Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations, Subpart C-Post-Award Requirements, Financial and Program Management § 74.21 Standards for financial management systems.

FRC's agreement with PBS clearly required compliance with EDGAR:

> (e)(ii) "[…] Subcontractor must comply with the applicable administrative requirements of OMB Circular A-110 (2 CFR Part 215) / 34 CFR Part 74 and OMB Circular A-133. Subcontractor's financial management system must provide records that identify adequately the source and application of funds of federally-sponsored activities….

Public Broadcasting Service National Program Service Production and Distribution Agreement: Peg + Cat Season 1, Exhibit D-1, Section 4-Payments.

FRC accounted for film production expenses based on FASB accounting standard ASC 926. Therefore, it capitalized its film costs related to PBS production agreements. However, for other federally funded programs with cost reimbursement grants (e.g. NSF), it expensed its federal expenditures.

FRC tracked the sources and uses of federal funding differently for RTL federal funds versus other federal funds. It did have a discrete project number and project accounting system to track total project costs funded in accordance with its production series budget, but it comingled RTL funds with PBS and CPB and other funding by detail budget line category. Its accounting system also identified the RTL, PBS, and CPB funding sources within its general ledger based on the funding distribution schedule in the agreement, but the funds were co-mingled in the same revenue general ledger account.

For other federal funding, such as NSF funds, FRC had a separate subproject and detail general ledger accounts to track the federal funds and report these discrete costs on its A-133 audit, as required. FRC applied the RTL funds when it recognized the revenue in its general ledger based on the PBS/CPB/RTL agreement payment schedule to a portion of the total actual capitalized film expenditures by year and reported this amount on its A-133 audit for federally funded RTL expenditures.

Because FRC did not discretely account for the use of RTL funding it was not in full compliance with the terms of the agreement for the federal funding, and we could not specifically identify RTL federally funded costs by budget line category.

Subcontracts with RTL funding

Our audit found that FRC awarded a fixed price contract to a Canadian contractor without including a provision granting access to the contractor's books and records as is required for negotiated fixed priced contracts with federal funds and important to audit federal RTL funds.

The PBS/CPB/RTL agreements included federal provisions for procurement regulations that dictate the following:

> § 74.48 Contract provisions - The recipient shall include…the following provisions in all contracts. The following provisions must also be applied to subcontracts…
>
> (d) All negotiated contracts (except those for less than the small purchase threshold) awarded by recipients must include a provision to the effect that the recipient, ED, the Comptroller General of the United States, or any of their duly authorized representatives, must have access to any books, documents, papers and records of the contractor which are directly pertinent to a specific program for the purpose of making audits, examinations, excerpts and transcriptions.

EDGAR Title 34 CFR Subtitle A Part 74-Administration of Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations, Subpart C-Post-Award Requirements, Procurement Standards, § 74.48.

For Peg + Cat, FRC said it spoke with several film animation production subcontractors, then negotiated the fixed price PSA contract with 9 Story, a Canadian production company. The contract allowed FRC and its co-venture producer access to the PSA subcontractor's books and records but did not incorporate the federal access provisions, as required. [9]

Since FRC did not include federal access provisions in its negotiated contract, it was noncompliant with the RTL provisions in the PBS/ CPB/RTL agreement and federal regulations.

Recommendations

8) We recommend that CPB periodically monitor PBS's oversight of its large subrecipients to verify that grant recipients comply with RTL requirement for the following:
   a) project budgets, financial reports, and accounting records separately identify the use of federal funds; and
   b) negotiated subcontracts include access provisions for CPB as required by RTL.

FRC Response

FRC disagreed with our federal compliance findings. FRC stated that it accepted that the agreement for Peg + Cat contained federal provisions (Exhibit D-1) but believe it followed all such requirements as practicable and as evidenced by its "clean" Office of Management and Budget (OMB) A-133 audit.

Tracking Disbursements by Project

FRC asserted that the level of discrete accounting OIG said is required to be in compliance with federal provisions was not included as a precondition of the approved project budget. If required in the future to account for costs on a line specific basis, FRC would be happy to do so.

[9] FRC formed co-ventures with its Canadian production partners to obtain Canadian tax credits that offset approximately 30 percent of the contracted costs. The PSA agreements are with wholly owned entities of the co-venture partner.

Procurement

FRC did not agree that it was noncompliant with federal procurement provisions. It asserted that because of conflicts in the agreement between referenced general federal provisions, specific exhibits, and the main body of the agreement, it considered the main agreement the governing document. Further, FRC stated because the agreement specified, required, and approved the Canadian animation production company, all procurement requirements were voided by the provisions of the agreement. Finally, because FRC does not believe the federal procurement provisions apply to its contract with 9 Story and because it followed OMB A-133 rules that exclude both commercial and non-U.S. based vendors from such provisions, it does not agree that its PSA contract should include federal access for CPB and RTL funding.

Award Monitoring

FRC believes that over the three-year sub-award period, all compliance issues had been monitored and discussed with PBS staff responsible for RTL compliance. FRC was not aware of any aspect of its administration of the production that did not meet PBS's approval.

OIG Review and Comment

Recommendation eight is directed toward CPB, therefore we consider it unresolved pending CPB management's final management determination. We have modified our recommendation to include monitoring and ensuring future RTL funded project budgets separately identify the application of RTL federal funds. Based on FRC's response we eliminated our finding on not complying with RTL sole source procurement requirements. Our analysis of FRC's response is provided below.

Tracking Disbursements by Project

We agree with FRC's assessment that a separate budget would have ensured discrete tracking of RTL expenses. We noted in another PBS/CPB/RTL production agreement, the independent producer's budgets and cost reports separately identified RTL costs from other funding sources. As a result, we modified recommendation eight to include requiring independent producers to separately identify the use of RTL funds in their budgets and separately report RTL costs in their financial reports in future agreements.

Procurement

We do not agree that the RTL federal procurement provisions did not apply to FRC and its negotiated fixed price contract with the Canadian producer. As pass through RTL sub-awards, both the PBS and FRC agreements had to comply with RTL requirements to document sole source procurement award justifications and contracts for negotiated fixed price procurement subcontracts.

Based on FRC's response to the draft report, we will accept that the agreement's Budget Narrative, Exhibit B, identified the Canadian producer to be used in the agreement and thus provided a basis for the use of a sole source contract, and we have revised our finding accordingly. However, this justification was not sufficient to address FRC's responsibilities to ensure access to contractor's records when the contract is negotiated, especially in a case such as this where access to the contractor's records was necessary to verify total project costs reported to PBS/CPB. As discussed previously, FRC included provisions in its PSA contract with 9 Story that gave FRC access. FRC requested certain financial records from its contractor and provided them to us for our audit, as we noted in our scope and methodology, Exhibit F.

FRC said it applied the OMB A-133 audit requirement guidance when drafting its subcontract with 9 Story and determined that it did not apply to commercial and non-U.S. based vendors. While the OMB A-133 audit requirements did not apply, this same A-133 guidance did require FRC, as subrecipient and the pass-through entity, to establish requirements as necessary to ensure for-profit contractor's compliance.

Although, FRC argues, that the Canadian producer is a commercial vendor and not subject to the OMB A-133 compliance and federal regulations, FRC as the subrecipient of RTL funds is responsible for following procurement regulations under EDGAR Title 34 CFR Subtitle A Part 74-Administration of Grants, Subpart C-Post Award Requirements, Procurement Standards, § 74.48 apply. Specifically, § 74.48 (d) requires negotiated contracts to include audit access provisions for the federal awarding agency, the Comptroller General of the United States, or any of their duly authorized representatives.

Award Monitoring

FRC stated that PBS was monitoring FRC's RTL requirements and had not made FRC aware of any noncompliance issues. PBS officials also commented that they worked closely with FRC on RTL requirements. However, PBS approval of the Canadian subcontractor and related budget did not negate FRC's responsibility to include appropriate federal procurement provisions in its subcontracts. Based on FRC's response recommendation eight remains unresolved pending CPB final management decision.

Exhibit A

Peg + Cat, Season 1 (40 Episodes)
Final Financial Report - May 29, 2015
CPB Grant Number 14616

Budget Category[10]	Budget	Actual Reported	Variance (under)/over	% Variance
Revenue[11]				
PBS/RTL	$7,990,845			
CPB	3,000,000			
PBS	2,000,000			
Production Deficit	3,810,937			
Total Project Funds	**$16,801,782**	**-**		
Expenses				
Pre-production	$80,000	$79,000	($1,000)	(1.3%)
New York Unit				
Producer Unit	1,767,263	1,579,520	(187,743)	(10.6%)
Script/Story Development	585,343	490,549	(94,794)	(16.2%)
Research	274,475	194,352	(80,123)	(29.2%)
Voice Talent	152,275	117,749	(34,526)	(22.7%)
Production Staff	307,596	291,849	(15,747)	(5.1%)
Design	552,584	586,487	33,903	6.1%
Animation/Layout/Storyboard	1,101,316	1,182,877	81,561	7.4%
Music & Audio	709,955	797,607	87,652	12.3%
Sound Editorial	302,000	151,420	(150,580)	(49.9%)
Interstitial Production	60,994	14,877	(46,117)	(75.6%)
Production Expenses	519,500	575,421	55,921	10.8%
Legal	160,000	10,416	(149,585)	(93.5%)
Accounting	32,500	32,500	-	0.0%
Travel	179,800	83,040	(96,760)	(53.8%)
Staff Benefits	576,000	476,306	(99,694)	(17.3%)
Total New York Unit	**7,281,601**	**6,584,968**	**(696,633)**	**(9.6%)**
Canadian co-venture partner				
Animation Production Services[12]	**8,157,241**	**8,522,990**	**365,749**	**4.5%**
Pittsburgh Unit				
Legal	201,000	103,093	(97,907)	(48.7%)
Audit	45,000	45,000	-	0.0%
Insurance	46,000	34,939	(11,061)	(24.0%)
Office Expenses	13,700	-	(13,700)	(100.0%)
Production Travel	38,095	17,309	(20,786)	(54.6%)
Total Pittsburgh Unit	**343,795**	**200,341**	**(143,454)**	**(41.7%)**
Production Subtotal	**15,862,637**	**15,387,299**	**(475,338)**	**(3.0%)**
Transmedia Suite	864,145	842,687	(21,458)	(2.5%)
Station Relations	75,000	56,089	(18,911)	(25.2%)
Non Broadcast Subtotal	**939,145**	**898,776**	**(40,369)**	(4.3%)
Total Direct Costs	**$16,801,782**	**$16,286,075**	**($515,707)**	**(3.1%)**

[10] For report presentation purposes, we summarized FRC's final detailed budget line item expense report into these line item categories.
[11] FRC did not report grant revenues on its final financial report and stated revenues were reported pursuant to Exhibit C of the grant agreement on its Participation and Recoupment report as shown in Exhibit E.
[12] $3,088,756 of animation costs reported are not recorded in FRC's general ledger and the amount reported on its final financial report is based on fixed price contract with 9 Story converted from Canadian dollars to U.S. dollars.

FRC Notes:

1) Budget amounts have been updated for amendments 2 and 3, which add $350,136 to the transmedia and parent child activity categories.
2) Canadian animation cost categories are now being reported according to the fixed price contract with 9 Story. Previously it was requested that we report 9 Story costs. We are now following GAAP and reporting our costs not 9 Story costs.
3) Since the original budget was set, we have revised the services contract with 9 Story to take into account the extra animation work required for the series. The extra costs are reflected in the relevant line items.

Exhibit B

The Fred Rogers Company – Daniel Tiger's Neighborhood Season 2
Interim Cost Report as of June 30, 2015
CPB Grant Number 15059

Budget Category[13]	Budget (1)			Actual Reported (1)			Questioned
	CPB	**PBS**	**Total**	**CPB**	**PBS**	**Total**	
Revenue [14]							
PBS			$2,625,000				
CPB			1,708,772				
Canadian Tax Credits			1,350,235				
Co-venture Investment			861,119				
Foundations			830,000				
Foundation			750,000				
Anonymous			500,000				
Distribution Advance			401,856				
Total Project Funds			**$9,026,982**				
Expenses							
Fred Rogers Company							
Executive Producer	$118,750	$561,594	$680,344	$126,588	$497,500	$624,089	
Rights Acquisition		300,500	300,500		300,500	300,500	
Core Unit							
Legal Services		132,220	132,220		66,721	66,721	
Accounting and Audit		74,725	74,725		37,005	37,005	
Insurance		49,282	49,282		65,998	65,998	
Production Staff		86,228	86,228		84,248	84,248	
Travel		26,059	26,059		24,415	24,415	
General Expenses		13,241	13,241		4,887	4,887	
Core Unit - Community-Based Interstitials							
Production Staff	308,207	(11,835)	296,372	386,782	(77,356)	309,425	$136,443
Freelance Crew	124,688	(4,788)	119,900	92,024	(18,405)	73,619	$31,962
Location Expenses	36,813	(1,414)	35,399	27,760	(5,552)	22,208	$11,841
Travel	17,581	(675)	16,906	14,511	(2,902)	11,608	$9,971

[13]For report presentation purposes, we summarized FRC's final detailed budget line item expense report into these line item categories.

[14]CPB grant agreement includes certification of final financial accounting requirements that includes a statement that the final report conforms to the budget reflected in Exhibit B of the agreement, which identified funding sources. CPB's Terms and Conditions also require accounting records to support project funding.

Exhibit B (continued)

The Fred Rogers Company – Daniel Tiger's Neighborhood Season 2
Interim Cost Report as of June 30, 2015
CPB Grant Number 15059

Budget Category	Budget (1)			Actual Reported (1)			Questioned
	CPB	PBS	Total	CPB	PBS	Total	
Equipment Purchases	8,869	(341)	8,528	10,526	(2,105)	8,421	$10,526
Office Space		67,144	67,144		67,144	67,144	
Animation[15]							
Producer		676,895	676,895		676,895	676,895	
Director		273,970	273,970		273,969	273,969	
Production Staff		605,892	605,892		605,892	605,892	
Cast and Record		429,420	429,420		429,420	429,420	
Key Creative		610,672	610,672		610,672	610,672	
Layout, Design		1,161,439	1,161,439		1,161,439	1,161,439	
Storyboard/Cleanup		822,310	822,310		822,310	822,310	
Scene Planning		178,108	178,108		178,108	178,108	
Animation		1,285,056	1,285,056		1,285,056	1,285,056	
Transportation		24,336	24,336		24,336	24,336	
System Administration		159,490	159,490		159,490	159,490	
Office/Studio Expenses		277,482	277,482		277,482	277,482	
Interstitials		19,638	19,638		19,638	19,638	
Rentals		156,805	156,805		156,805	156,805	
Computer Equipment		77,775	77,775		77,775	77,775	
Post Production Staff		59,794	59,794		59,795	59,795	
Post Video Editing		151,436	151,436		151,436	151,436	
Post Audio Editing		232,071	232,071		232,071	232,071	
Online Editing		101,923	101,923		101,923	101,923	
Mix		86,243	86,243		86,243	86,243	
Packaging/Generics		83,107	83,107		83,107	83,107	
Music		156,805	156,805		156,805	156,805	
Versioning		92,136	92,136		92,137	92,137	
General Expenses		878,558	878,558		878,558	878,558	
Contingency		179,729	179,729		179,729	179,729	
New York Unit							

[15] Reported based on fixed price animation costs converted from Canadian dollars to US dollars of $7,305,400 plus 20.2 percent indirect costs. A total of $3,422,340 of 9 Story's direct costs were not recorded in FRC's general ledger as of interim report date June 30, 2015. After final financial reporting and payments to 9 Story, approximately $2.5 million in costs incurred by 9 Story will not be recorded on FRC's books.

Exhibit B (continued)

The Fred Rogers Company – Daniel Tiger's Neighborhood Season 2
Interim Cost Report as of June 30, 2015
CPB Grant Number 15059

Budget Category	Budget (1)			Actual Reported (1)			Questioned
	CPB	PBS	Total	CPB	PBS	Total	
Executive Producer		982,663	982,663		904,851	904,851	
Writing	69,210	450,728	519,937	69,210	436,747	505,957	
Research	20,000	130,250	150,250	20,000	126,210	146,210	
Production Staff	68,243	444,434	512,677	68,243	430,649	498,892	
Office Expenses	26,448	172,243	198,691	26,448	166,900	193,348	
General Expenses	5,760	37,512	43,272	5,760	36,348	42,108	
Production Travel	13,050	38,035	51,085	13,050	36,661	49,711	
Production Subtotal	**$817,618**	**$12,328,896**	**$13,146,514**	**$860,902**	**$11,961,556**	**$12,822,458**	**$200,744**
Digital (3)	306,250	420,700	726,950	141,854	360,786	502,641	
Member Station Support	206,250	34,150	240,400	91,465	648	92,114	$42,903
Promotion		240,400	240,400		186,926	186,926	
Community Engagement	378,654		378,654	375,423		375,423	
Non Broadcast Cost Subtotal	**$891,154**	**$695,250**	**$1,586,404**	**$608,743**	**$548,360**	**$1,157,103**	**$42,903**
Total CPB/PBS Project Budget	**$1,708,772**	**$13,024,146**	**$14,732,918**	**$1,469,645**	**$12,509,916**	**$13,979,562**	**$243,647**
Excess Indirect Costs included in CPB budget line items above							**$68,392**
Total CPB Questioned Costs							**$312,039**

(1) Totals include overhead.

Exhibit C

Peg + Cat Season 1 CPB Excess Funding
OIG Calculation based on Actual

Project Costs and Funding Sources	Peg + Cat Season 1 Actuals	Notes
Final Financial Report 5/29/15 Costs Reported	**$ 16,286,075**	
Funding Sources		
CPB	$ 2,905,273	CPB deobligated $94,727
RTL	$ 7,990,845	
PBS	$ 2,000,000	
Total CPB/RTL/PBS	**$ 12,896,118**	Through Amendment #3
Initial Producer Surplus (deficit)	$ (3,389,957)	
Reconciled Canadian Costs not on FRC books guaranteed funding ($CDN 3,166,920 contract = converted $US 3,114,054 converted fixed price contract for cost report less currency differential FRC $25,299)	$ 3,088,756	$US per fixed price contract
Total Budgeted Actual Funding	**$ 15,984,874**	
Producer Surplus (deficit)	$ (301,201)	
NSF Funding Direct Production	$ 915,749	* NSF reimbursed FRC for direct production expenditures included in total costs above
Total Funding	**$ 16,900,623**	
Surplus (deficit) actual direct costs	***$ 614,548***	Excess PBS/CPB funding
CPB %	59.2%	
CPB Excess Payment	***$ 363,812***	

OIG Analyis of Additional Recoupment for NSF Application of funds	Peg + Cat Season 1 Actuals	Notes
Additional Recoupment	$ (3,294,809)	(20.2% indirect on original budget $16.3 mil)
NSF Funding Indirect Production	$ 184,981	** NSF overhead on direct production at 20.2%
Foundations	$ 870,000	
Total Net Underwriting	**$ 1,054,981**	
Producer Deficit	**$ (2,239,828)**	

Exhibit D

Peg + Cat Season 1 – Final Financial Report May 29, 2015 with NSF Funded Costs Segregated (OIG Prepared)

Account Number	Category Description	Budget	Reported Actual in Final Financial Cost Report	NSF Direct Production Costs	Project Costs net of NSF Funded Expenses funded by PBS/CPB/RTL /FRC/9 Story
	Pre-Production Total	$80,000	$79,000		$79,000
	New York Unit				
50-01	Executive Producer	1,011,328	960,692	388,839	571,853
50-02	Supervising Producer	395,050	365,144		365,144
50-03	Line Producer	200,211	23,949		23,949
50-04	Associate Producer	160,674	229,736		229,736
50-00	Total Producer Unit	1,767,263	1,579,520	388,839	1,190,681
51-00	Script/Story Development	585,343	490,549		490,549
52-01	Curriculum Consultants	80,000	40,690	10,000	30,690
52-02	Research Director	135,000	138,465	102,252	36,213
52-03	Research Coordinator	14,475	5,800		5,800
52-04	Research Location expenses	12,000	1,031		1,031
52-05	Research Supplies	12,000	519		519
52-06	Children Focus Group costs	15,000	5,250		5,250
52-07	Research Fees/Giveaways	2,000	2,254		2,254
52-08	Research Craft Service	4,000	344		344
52-00	Total Research	274,475	194,352	112,252	82,101
53-00	Voice Talent	152,275	117,749		117,749
54-00	Production Staff	307,596	291,849		291,849
55-00	Design	552,584	586,487		586,487
56-00	Animation, Layout, Storyboard	1,101,316	1,182,877		1,182,877
57-00	Music & Audio	709,955	797,607		797,607
58-00	Sound Editorial	302,000	151,420		151,420
59-00	Interstitial Production	60,994	14,877		14,877
80-01	Office Space	170,000	248,581		248,581
80-02	Furniture	29,250	34,948		34,948
80-03	Telephone and ISP	22,400	10,341		10,341
80-04	Copier and Fax	9,600	2,266		2,266
80-05	Workstations and Printers	178,100	145,179		145,179
80-07	Servers, Storage and Backup	56,250	66,021		66,021
80-08	Office Supplies	46,400	41,652	84	41,568
80-09	Miscellaneous	7,500	26,433		26,433
80-00	Total Production Expenses	519,500	575,421	84	575,337
81-00	Legal	160,000	10,416		10,416
82-00	Accounting	32,500	32,500		32,500
83-01	Travel	179,800	83,040	196	82,845
83-00	Total Travel	179,800	83,040	196	82,845
84-01	Health Insurance-employer contribution	576,000	476,306	25,400	450,906
84-00	Total Staff Benefits	576,000	476,306	25,400	450,906
	New York Unit Total	**7,281,601**	**6,584,968**	**526,771**	**6,058,197**
	Total Animation Prod Services-Canada-9 Story (In U.S. $)*	**8,157,241**	**8,522,990**		**8,522,990**

Exhibit D (continued)

Peg + Cat Season 1 – Final Financial Report May 29, 2015 with NSF Funded Costs Segregated (OIG Prepared)

Account Number	Category Description	Budget	Reported Actual in Final Financial Cost Report	NSF Direct Production Costs	Project Costs net of NSF Funded Expenses funded by PBS/CPB/RTL/ FRC/9 Story
	Pittsburgh Unit				
40-00	Legal	201,000	103,093		103,093
41-00	Audit	45,000	45,000		45,000
42-00	Insurance	46,000	34,939		34,939
43-00	Office Expenses	13,700	-		
44-00	Production Travel	38,095	17,309		17,309
	Pittsburgh Unit Total	**343,795**	**200,341**		**200,341**
90-01	Producer	85,800	82,000	40,000	42,000
90-02	Site Design Package			2,500	(2,500)
90-03	Creative	9,600	8,282		8,282
90-04	VO Talent	19,965	27,922		27,922
90-05	Sound Editorial	12,100	13,900		13,900
90-06	Research	8,500	4,500		4,500
90-07	Developer - Online Games and Apps	703,440	679,343	346,479	332,864
90-08	Parent and Child Activity	24,740	26,740		26,740
90-09	Maintenance				
90-00	Transmedia Suite	864,145	842,687	388,979	453,708
91-00	Station Relations	75,000	56,089		56,089
	Total Non Broadcast Costs	**939,145**	**898,776**	**388,979**	**509,797**
	Total Preproduction	**80,000**	**79,000**		**79,000**
	Total Production	**16,721,782**	**16,207,075**	**915,749**	**15,291,325**
	Total Direct Costs	**16,801,782**	**16,286,075**	**915,749**	**15,370,325**
	Grand Total	**$16,801,782**	**$16,286,075**	**$915,749**	**$15,370,325**
	Overhead (non PBS/CPB line item)	-	-	184,981	
	Total NSF Production			1,100,731	
	NSF Research (non PBS/CPB line item)			1,033,383	
	Total NSF Expenditures			**$2,134,114**	
	*Portion Funded by Tax Credits				3,088,756
	Total Expenses PBS/CPB/RTL/FRC – Net of NSF direct production expenditures				12,281,570
	Total PBS/CPB/RTL funding received including CPB deobligation				12,896,118
	PBS/CPB Excess Funding				**$614,548**

Exhibit E

The Fred Rogers Company, Peg + Cat, Season 1
Recoupment and Participation Calculation: PBS/CPB
Cumulative to 9/30/15

Production Deficit	US$	$CND	
		0.9465	(1)
Budget in Agreement as amended (#2)	16,451,646.00		(2)
Sources of Funding			
Exhibit PBS	2,140,709.00		
RTL	7,500,000.00		
CPB	2,905,273.00		(3)
	12,545,982.00		
YTV	378,600.00	400,000.00	(4)
Federal Credits	426,076.44	450,160.00	
Provincial Credits	1,624,913.34	1,716,760.00	
Distribution Advance	567,900.00	600,000.00	
Net Revenue	1,106,778.57		
Distribution Expense	(241,896.53)		(5)
	864,882.04		
Total Funding	16,408,353.82		
Interest Charges	98,233.33		(6)
Surplus(Deficit)	**54,941.14**		
PBS Share Per Exhibit C 57%	**31,316.45**		
CPB Share per Exhibit C 18%	**9,889.41**		
Additional Producer Recoupment	3,294,809.00		(7)
Sources of Funding			
National Science Foundation	1,069,142.46		
Foundation A	270,000.00		
Foundation B	300,000.00		
Foundation C	300,000.00		
Total Funding	1,939,142.46		
Surplus (Deficit)	(1,355,666.54)		

Notes:

(1) This is an average of the rate between October 2012 and December 2014, which is the period in which the Canadian funds were used to support the production.

(2) Exhibit C (para. A8) to the agreement specifies that the Production Deficit is calculated using the costs set forth in Exhibit B.

(3) This amount was originally $3,000,000 but CPB reduced its funding for the series.

(4) This was originally forecast to be a sale to CBC for a considerably higher sum; CBC passed.

(5) Although there is a 5% cap on distribution expenses this may be amortized over three years.

(6) Exhibit C (para. A8) provides for interest at 2% over prime. This has been calculated quarterly.

(7) This additional recoupment can only be taken from Net Underwriting (Exhibit C, E.I.b).

Exhibit F

Scope and Methodology

We conducted our audit in accordance with *Government Auditing Standards* for financial audits to determine whether The Fred Rogers Company (FRC): a) submitted financial reports that fairly presented total project grant expenditures; b) incurred costs in accordance with grant requirements; and c) complied with grant requirements including federal Ready to Learn (RTL) terms. We performed our audit field work during the period May 2016 through November 2016.

The scope of the audit included reviews and tests of the costs reported by FRC on PBS/CPB/RTL Grant, Peg + Cat Season 1; and CPB Grant Number 15059 Daniel Tiger's Neighborhood Season 2, during the period July 1, 2012 through September 30, 2015. These financial reports are provided in Exhibits A and B.

In conducting our audit, we reviewed CPB's grant files and discussed the award and administration of the grant with CPB officials from the Office of Business Affairs, Office of the Chief Financial Officer, Education and Children's Content Operations, TV Programming as well as PBS officials. We also discussed with various FRC officials, including its Chief Operating officer, VP of Broadcast and Digital Media and Director of Finance, the grant agreements and related co-venture and distribution agreements, as well as management's policies and procedures. We also reconciled the financial data maintained by FRC in its accounting records to FRC's audited financial statements, along with contracts with its Canadian co-ventures and production service agreements, and general ledgers for the grants reviewed to the expenses it reported to CPB.

We tested the accuracy of grant expenditures that FRC claimed by performing financial reconciliations and comparisons to underlying accounting records to verify transactions recorded in the general ledger and reported to CPB on payment requests. We also evaluated compliance with the grant agreement terms, in part, by testing 136 or $3,069,600 judgmentally selected expenditures from the universe of $30,265,636 in expenses reported under the grants to supporting documentation maintained by FRC. In addition, we performed alternative procedures on the Canadian co-venture production service agreement expenses totaling $5,601,292 that were not recorded on FRC's books, including review of Canadian co-venture production company's general ledgers.

For the Peg + Cat grant, we reviewed FRC's procurement policies and procedures to determine if FRC was compliant with RTL federal procurement regulations when it awarded its vendor contracts. We also reviewed the Participation and Recoupment report to determine if ancillary revenues were received and reviewed the propriety of the report in accordance with agreement terms.

We also reviewed FRC's indirect cost rate methodology for compliance with CPB grant terms for costs incurred on Daniel Tiger's Neighborhood Season 2 production to determine reasonableness and allowability.

We gained an understanding of the internal controls over the preparation of the grant financial reports, cash receipts, and payment authorizations. We also gained an understanding of FRC's policies and procedures for compliance with CPB and RTL grant agreement terms for allowable costs. We used this information to assess risks and plan the nature and extent of our testing to conclude on our objectives. Further, to obtain reasonable assurance that financial reports submitted to CPB were free of material misstatements, we performed tests of compliance with certain provisions of law and grant agreement requirements, when noncompliance could have a direct and material effect on the grant report amounts.

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Exhibit G

William J. Richardson III
Deputy Inspector General
Corporation for Public Broadcasting
401 Ninth Street, NW
Washington, DC 20004

March 10, 2017

Dear Mr. Richardson:

Thank you for providing us with a copy of the OIG draft report No. APT1604-XXX dated February 8th, 2017 concerning "Peg + Cat" and "Daniel Tiger's Neighborhood". We have considered the report's findings, and welcome this opportunity to respond.

In the interests of brevity, we have used the following terms:

"CPB" means the Corporation for Public Broadcasting;
"DED" means the Department of Education;
"FRC" means The Fred Rogers Company;
"NSF" means the National Science Foundation;
"PBS" means the Public Broadcasting Service;
"PTV Entity" means PBS and CPB;
"RTL" means the DED 'Ready to Learn' pass-through grant funds.

In addition, to identify the various programs in production we have used the PBS NOLA code and a number representing the season. Thus, for example, "DTIG2" means the second season of "Daniel Tiger's Neighborhood" (episodes 41-65).

I. Questioned Production Costs (DTIG2)

(a) Pre-Term Costs

One of the OIG findings questions $243,647 in costs which were incurred before the grant start date of June 1, 2014.

<u>We agree with this finding.</u>

There is no disagreement between OIG and FRC that these costs were incurred in the production of DTIG2, only a finding that concerns timing. It is therefore worthwhile to review the DTIG2 schedule.

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The PBS agreement for the series is dated as of October 1, 2013, and was executed a few months later in January 2014. Its production schedule envisions a start date of July 22, 2013, which is before the effective date of the agreement itself. The agreement contains no provision equivalent to the CPB Grant for DTIG2 (governing a permitted start date for costs to be incurred), so any costs incurred in the production of the series in accordance with the Approved Budget are eligible for inclusion in the final financial report.

Part of the production (required by PBS, and in its budget) was a set of live-action 'interstitials'. Costs began to be incurred on the interstitials in early 2014.

A conversation began with CPB in the summer of 2014 which ultimately resulted in a grant of $1,708,772. The grant was dated as of June 1, 2014 but was not executed until December 2, 2014. This grant was not for general support of DTIG2 (which at the time had a deficit in the PBS agreement of $6.7 million), but was specifically allocated to certain parts of the production, including the interstitials described above.

By the time it was executed, the CPB grant was therefore providing for work that had already been under way for nearly a year. It appears that neither FRC nor CPB realized that the regular reports submitted to CPB from 2015 onwards contained costs that, although covered by the grant's work scope, had been incurred before the designated start date.

(b) Excess Indirect Costs

OIG questions $68,392 in indirect costs on DTIG2. We defer to OIG's interpretation of CPB's Terms and Conditions for Television, Radio and other Media Production Grants (April 2013) in this matter, and so we agree with this finding.

We feel it is helpful to provide some background here in terms of the procedures adopted.

Originally, we included in our grant request indirect costs at a rate of 20.2%, which is the historic rate that FRC has received from federal agencies for at least the last twenty years. [We provided OIG with evidence of multiple such grants, including the NSF grant used for PCAT1.]

CPB staff asked to see the original calculation approved by the relevant cognizant agency, but we were unable to find such supporting paperwork from so long ago. While accepting that other federal agencies had 'grandfathered' our 20.2% rate, CPB required that a fresh calculation be performed. Accordingly, we did this using a supplied pro forma, and arrived at a new rate of 35.91%. The parties subsequently decided to switch from a calculated to a negotiated rate, and agreed on 25%.

We applied this rate in all cost reports submitted to CPB during production. It was our assumption that the negotiated 25% was valid throughout the life of the grant, but OIG maintains that it should have been calculated on an ongoing basis for each year of the three-year period (resulting in the adjustment of $68,392). As noted above, we defer to OIG's understanding of CPB's Terms and Conditions. No other federal grant we have received has contained similar provisions.

Given the apparently complex and demanding nature of the required accounting for indirect costs, should we be fortunate enough to receive further CPB grant funding we are likely to forego any entitlement to such costs.

II Ancillary Revenues Distribution Understated (PCAT1)

(a) Producer Deficit or Surplus

This finding concerns participation statements due to the PTV Entity, in particular that for the period ending September 30th, 2015. Such statements are due every six months in perpetuity. FRC tries to ensure that its participation statements are accurate and reconciles all project costs and revenues to its books at the end of each fiscal year, but in the normal course of business it is to be expected that there will be rolling adjustments.

<u>We agree with some of OIG's findings in this matter</u>, and have accordingly made adjustments in a participation report for a subsequent period. With disagree with other findings, as detailed below.

The first participation statement for PCAT1 was due in March 2016 for the period ending December 31st, 2015, which is outside the period of OIG's review. However, because the agreement specified two different rates for back-end participation (with a change on September 30th 2015, half-way through a reporting period), FRC substituted two three-month participation reports for the first six-month report due, the first of which covered cumulative activity to September 30th, 2015. It is this report which OIG examined.

OIG states that in order to test the accuracy of this report, it was necessary to "calculate the producer deficit or surplus, which was not identified . . . ". We disagree with this statement, since we did identify a producer surplus on the report.

OIG made its own calculation based on the final costs of production and concluded that the surplus for the period was greater than that calculated by FRC. We disagree with this method. Unlike OIG, FRC did not use the final costs of production as shown in the final financial report; instead, it simply followed the provisions of the agreement (Exhibit C, A.8):

> "Production Deficit" means the difference between the total amount of funding secured to cover the direct production costs of the Series and the total direct production costs of the Series as set forth in the Series Budget attached as Exhibit B to the Agreement.

It may well have been the intention of the drafter of the agreement that this calculation should be performed using the *actual* direct production costs, rather than those *set forth in the Series Budget,* but this is a three-party agreement which cannot be arbitrarily changed by any one party. Its language in this context is clear and unequivocal.

We nevertheless believe that the method preferred by OIG, although not supported by the language of the agreement, is more equitable and customary in the industry. We have therefore adjusted the calculation of the initial deficit on a subsequent statement in line with this method. The cumulative effect of this change is not material. We look forward to amending the agreement to reflect this change in establishing the base point of the participation calculations.

(b) Interest Expense

In its calculation of the participation due at September 30, 2015, OIG says that

> FRC included interest expense as an additional source of funding in its calculation. We eliminated it in the OIG calculation because the only known deficit applied to the Canadian producer's costs, which were covered by the fixed price PSA contract and any related financing costs were never booked on the FRC general ledger.

<u>We agree, in part, with this finding.</u> FRC did, indeed, show interest expense as a source of funding, rather than as an expense. This was a mistake (in favor of the PTV Entity), and had the interest been shown properly, the project would have continued to be in deficit. We corrected this on a future statement.

Recoupment of interest is provided for in Section 8 of the agreement:

> PBS and CPB agree that Producer may recoup the Production Deficit, including interest charges on the amount of the unrecouped Production Deficit at prime plus two percent (2%), in full in accordance with Paragraph E.I. below.

It is not the case that "the only known deficit applied to the Canadian producer's costs, which were covered by the fixed price PSA contract and any related financing costs were never booked on the FRC general ledger". FRC calculated the unrecouped Production Deficit on a quarterly cash basis, subtracting all revenues from all costs. On this basis, the production was cash flow negative in the final quarter of 2012, and a quarterly charge was made in accordance with the provisions of the agreement on any negative cash flows throughout production. We explained this to OIG, but were not asked to provide any supporting calculations. FRC considers its method to be very reasonable compared to the way a commercial bank would have calculated such interest.

There is nothing in the agreement requiring such allowable interest costs to be 'booked on the FRC general ledger', but in future we will only finance productions with a commercial line of credit, and will therefore have an audit trail to the (presumably greater) costs incurred.

(c) OIG Calculation of Producer Surplus

The OIG table with this title shows a difference of $140,709 between FRC and OIG's 'source of funding' figure for PBS, and a difference of ($490,845) between FRC and OIG's stated funding from RTL. We agree with these OIG adjustments. As noted elsewhere, there are many amendments to this agreement. The variations in this table can be attributed to the second and third amendments to the agreement: although the relevant amounts were added to the budget for cost reporting purposes in the final financial report, only the first amount (from Amendment #2) was included in the funding sources reported by FRC on the participation statement. We corrected this on a subsequent statement so that the aggregate net total of PBS/RTL and CPB funding matched OIG's calculations.

(d) OIG Footnote #4

This says:

> We note that the negotiated $3,294,809 amount was based on a generous calculation of FRC's unfunded overhead costs (20.2 percent of original total budget of $16.3 million). Based on our audit, FRC's unfunded overhead costs were estimated at only $2,239,264 without reducing the co-venture costs in the base to the $25,000 federal government limit. The 20.2 percent rate was excessive and not supported in FRC's records. Further, the base the rate was applied to include $3.9 million in co-venture budgeted costs that were not even on FRC's books.

We disagree with all these observations. As we have noted elsewhere,

- The sum of $3,294,809 was not based on an overhead calculation, nor was it a producer fee, nor was it described in the agreement by any name whatever. It is a *contractually negotiated amount* which the producer is entitled to recover from certain revenue sources.
- Any calculation of 'FRC's unfunded overhead costs' is entirely moot. There is no provision in the agreement for FRC to recover *any* overhead costs.
- Any suggestion that 'the 20.2% rate was excessive' presumes that there was such a rate. There was not.
- Any objection to applying the rate to 'co-venture budgeted costs' without a $25,000 federal limit is irrelevant if there was no rate applied to *anything* in the first place.

(e) Additional Producer Recoupment

This is FRC's term, used on participation statements, for the otherwise unnamed sum of $3,294,809 contained in the agreement, and referred to above. OIG objects to certain NSF funds being applied in this section of the calculation on the grounds that they were used for supporting the production. <u>We disagree with OIG's findings here.</u>

For the purposes of the calculation of the participation report required by Exhibit C, there are, as we shall explain in greater detail below, various types of revenues. There are also two separate 'running tabs' - (a) one for a back-end share for the PTV Entity, and (b) one for the recoupment of the producer's $3,294,809. *All* revenues are applied to the direct production deficit until it has been extinguished, and neither of the running tabs is active. Once the tabs are in operation, only certain revenues may be applied to (b), the $3,294,809. Whether any of these revenues have been used to fund the production at any previous time (and many have) is entirely irrelevant. Exhibit C concerns itself solely with the *origin and nature* of the revenue stream and contains no qualifications concerning the *purpose* for which the revenue may have previously been used (if any). It is a dynamic mechanism which assumes continuing revenues from the exploitation of the property, and which provides for the division of those revenues between the various parties. FRC's participation reports follow it faithfully. This issue is further examined in III(c), below.

III. Over-Recovery of Production Expenses (PCAT1)

OIG says that its audit "identified significant deficiencies in internal control in financial reporting to prevent the over recovery of PBS/CPB production costs for this project totaling $614,548", contending that "FRC was reimbursed in excess of the total production costs for the project": <u>we dispute this finding and affirm that all RTL, PBS and CPB funds received were solely used to fund the direct costs of production</u>.

(a) Reimbursement.

At the point that amendment #3 was concluded, the agreement contained an Approved Budget of $16,801,782, and also provided for funding by the PTV Entity of $12,990,845. The agreement does not separately specify for which costs this funding may be used, so the OIG term "PBS/CPB production costs for this project" has no meaning. It is of the essence of the agreement that PTV entity funding for the series is fungible and, at best, it amounts to 77% of the total budget.

It is wrong to assume that the PTV Entity funds were being provided on a cost-reimbursement basis. As OIG notes elsewhere, the agreement governing this production is 'complex in nature'. It also contains inherent contradictions: OIG quotes language affirming that "all funds are provided on a cost reimbursement basis only and that in no event will any portion of the Series Payment be disbursed or applied by Producer for any purpose other than the Series production hereunder" (6.2).

If, in this context, the term 'cost reimbursement' merely means that funds may only be used for Series production, then FRC faithfully observed this provision. On the other hand, if the term is to be understood in its usual sense (as described, for example, in CFR Title 48, Chapter 1, Subchapter C, Part 16), since the PTV Entity was providing only partial funding, in order for there to be cost reimbursement there would need to be a definition of which specific costs were eligible, which there was not. There would also need to be a mechanism for the payment of costs that had been incurred and were eligible for reimbursement. There was not. To the contrary, and notwithstanding the language of section 6.2, the agreement also provides for funds to be paid on a basis which is *not* dependent on cost reimbursement. There are payment provisions in Exhibit D (for payment of the entire amount of PTV Entity funding) which are concerned specifically and solely with deliverables, for example:

> "Payment due on or about ten (10) to fifteen (15) business days after receipt of and approval by PBS of 6 rough cuts and final programs for episodes 135-140 with an invoice on or about December 10 2014" [$400,000]

This payment is binding upon PBS and CPB once the delivery has been made, regardless of whatever costs have actually been incurred at the time. Such a provision for payment on an exchange transaction basis (i.e. based on delivered portions of the complete work) is incompatible with payment on a purely cost reimbursement basis.

This issue is further highlighted by the provisions of Section 6.2 concerning de-obligation:

> "The CPB Funding provided hereunder shall be subject to proportional de-obligation in the event the Series is completed under budget, unless CPB written consent to the contrary is obtained. PBS shall also have the right to proportionally reduce its funding if the final actual costs are less than the costs projected in the PBS approved Budget."[1]

Clearly, such a provision would have no purpose if PTV Entity funding were being provided on a true cost reimbursement basis; equally clearly, the language was present because the intention was to make payment on the basis of Exhibit D.

FRC considered the provisions of Exhibit D to be precedent and binding on the parties, and thus to negate the cost reimbursement provisions, and so, apparently, did PBS. We invoiced PBS for payments related to this production on the basis of Exhibit D, and PBS paid such invoices on the same basis. We therefore do not consider *any* of the PTV entity payments as reimbursements, but, as we will show below, even if they were, FRC was not reimbursed in excess of the total production costs.

We believe that future agreements need to avoid this confusion. Although it will be more expensive for the PTV Entity, we would, in future, be happy to work on a true cost

[1] Because PCAT1 was produced with a 3% budget saving, CPB did exercise its right of rescission and so its funding of $3,000,000 was, in fact, reduced to $2,905,273. PBS did not reduce its funding.

reimbursement basis and remove the Exhibit D payment schedule, or continue to provide a payment schedule based on deliverables and remove language concerning cost reimbursement. In either case, we will always warrant that "in no event will any portion of the Series Payment be disbursed or applied by Producer for any purpose other than the Series production hereunder", which has always been the case.

(b) "In excess of the total productions costs . . ."

We believe that the agreement required the PTV Entity to pay $12,500,000 to the producer. At the time of the submission of the Final Financial Report, showing total production costs of $16,286,075, the funding received from the PTV Entity was, in fact, $11,915,709. Even though the Final Financial Report contained, at PBS's specific request, costs which were not on FRC's books (discussed below), booked costs were approximately $13.2 million, still in excess of PTV Entity funding.

FRC embarked on this production with a significant deficit, and through its own efforts secured outside investment, foundation funding and an NSF grant in support of the production. Unlike the PBS/CPB agreement, the NSF grant was unequivocally made (and operated) on a true cost reimbursement basis, resulting in funding of $1,069,142. Unlike the PBS/CPB agreement, the NSF grant specified which budget line items were eligible for reimbursement. None of the other sources of funding secured were provided on such a basis, being completely unrestricted. Therefore, even *if* we were to consider the PTV entity funding as a reimbursement, the total reimbursed funds on this project were $12,984,851, still not in excess of total costs.

The agreement in any case envisioned the possibility that the total ultimate funding would be in excess of total ultimate costs, and contained extensive provisions dealing with the surplus, which we discuss below.

(c) "FRC asserts that the NSF funds are considered "net underwriting""

This part of the OIG findings appears to confuse the provisions of the agreement, and does not accurately reflect discussions between OIG and FRC during the audit.

We have already stated, above, and we repeat, that all NSF funds were provided on a cost reimbursement basis and were applied solely to the production.

It is certainly true that we consider NSF funds to be 'Net Underwriting' for the purposes of Exhibit C, Section 6. This section clearly encompasses such foundation funding and provides that no 'Finder's Fee' may be deducted from 'Gross Foundation Grants & Funding'. Properly, no Finders Fee was or will be deducted from NSF funds by FRC. Section E (I) (a) defines "Net Underwriting" as "Projected Funding, Net Corporate Underwriting, Foundation Grants and Funding". Contrary to OIG's opinion, we believe that NSF funds can *only* be classified as Net Underwriting.

In Exhibit C, the agreement presumes that since the PTV Entity is funding only part of the production, there will be an initial production deficit. It provides a mechanism for the distribution of any subsequent surplus to both PBS and CPB, and separates costs and revenues each into two categories, thus:

(a) Revenues *before* and (b) *after* recoupment of the Production Deficit; and

(i) Direct costs of production, and (ii) the sum of $3,294,809.[2]

The agreement provides in case (a) for all revenues to be retained by the Producer until the Production Deficit is extinguished. After that, (b), revenues are divided into two streams:

(1) Net Underwriting, and (2) all other sources of revenue

Only the former may be applied to recoupment of the sum of $3,294,809 by the producer; the latter is split between FRC (25%) and the PTV Entity (75%). As noted above, Net Underwriting includes grants like the NSF funding, and other revenues might include royalties from such sources as the exploitation of home video rights, or foreign television sales.

The participation period for the PTV Entity is in perpetuity, and statements are due every six months. Obviously, at the beginning of the exploitation period, type (2) royalties will be scant, because the exploitation described above may not yet have begun. On the other hand, foundation funding (type 1) may have already been secured during production. In terms of accounting, the cost of the production is a fixed and determined figure at the beginning of the participation accounting period, but it is reasonable to expect that in the course of 'perpetuity' there will be new revenues of both type (1) and (2).

OIG says that FRC claims it can "change the application of these funds between expense categories as cash flow warrants". What we are actually saying is that we can change the *application of these revenues for participation accounting purposes*. Our approach is entirely consistent with the provisions of Exhibit C, and has nothing at all to do with the fact that all NSF funds were originally used for the production.

It was the case that the Producer Deficit could initially only be extinguished by applying Net Underwriting, but later in the reporting cycle there were sufficient other, new, royalties to allow the deficit to remain extinguished, pay a participation to the PTV Entity, and to reclassify the Net Underwriting to support the recoupment of the $3,294,809.

Thus it is that, at the time of writing, FRC has delivered the series on time and under budget, recouped the direct cost deficit, paid the PTV Entity approximately $974,000 and, of the permitted $3,294,809, has recouped $1,939,142. This *entire* sum was not

[2] As already noted, FRC does not, contrary to OIG's comments, consider this a producer's fee or an amount to cover unfunded overhead costs. The agreement provides no name or purpose for this sum, which FRC considers to be a negotiated feature of the back-end profit split. See II (d), above.

retained by FRC but used to fund the second season of *Peg + Cat*, which remains in deficit to this day.

(d) Canadian Funding Sources

OIG notes, correctly, that different exchange rates were used in the Approved Budget for the cost of Canadian animation work, and in the participation report when crediting the funding value of Canadian co-venture contributions.

The rate used for the Canadian production components in the original budget was simply the rate that was current at the time the budget was locked for the purposes of the PBS and CPB agreement. Since the Production Services Agreement called for payments to be made in Canadian Dollars, FRC experienced exchange rate gains and losses against the rate previously specified in the Approved Budget in the course of making payments to Canada.

To further complicate the matter, FRC did not pay for all the Canadian work specified in the Approved Budget and Production Services Agreement, because it was partly funded in Canada by the Canadians themselves. By structuring the deal this way and taking advantage of Canadian incentives of one kind or another, FRC was able to deliver to the PTV Entity approximately US$3 million in external funding for the series. The appropriate exchange rate for recording this Canadian contribution is not something that the agreement addresses, and we are open to any reasonable proposal if the PTV Entity feels that FRC's chosen solution - an average of the exchange rates we experienced when making Canadian payments in the course of the production - is the wrong approach.

(e) Reconciliation

OIG attempted to reconcile cost reports submitted to PBS and CPB with FRC's books. Such a reconciliation is not required in the agreement, and FRC explained at the beginning of OIG's audit that it was never going to be possible.

Of course, if the budget for the series had only included Canadian costs which were U.S.-funded, and if FRC's cost reports only showed what it actually sent to Canada, then it would have been possible for OIG to easily reconcile such cost reports to FRC's books, with the only likely budget variation being exchange rate gains or losses.

Unfortunately, PBS and CPB did not wish to present either the budget or the cost reports this way, and asked for them to show *all* costs on the production. Clearly, costs being incurred in Canada, and separately funded there, do not show on FRC's books, so it was not possible to reconcile cost statements with the producer's books. This process further becomes somewhat academic when it is noted that the Canadian Production Services Agreement is a fixed-price contract, and so whatever the actual costs of the work undertaken in Canada, and regardless of whether they were over or under budget, FRC would always be required to pay the same amount. Budget variations would thus have no impact on the actual production cost, and thus be of no consequence to either FRC or the PTV Entity.

Next time we undertake any work which has a Canadian dimension we will have a proposal for consideration which we believe will remove this confusion and be acceptable to PBS and/or CPB.

IV Federal Award Noncompliance (PCAT1)

(a) Tracking disbursements by projects

We accept that the agreement for PCAT1 contained provisions (in Exhibit D-1) relating to the use of RTL funds, and to the extent that it was practicable, we believe we followed all such requirements. FRC's use of federal funds was subject to several successive years' OMB A-133 audits performed by independent public accountants. These 'clean' audits show that FRC complied in all material respects with the requirements of Uniform Guidance.

OIG finds that FRC "co-mingled RTL with PBS/CPB expenses within its project accounting records". Since the Approved Budget in the agreement did not define or distinguish between RTL expenses, PBS expenses, CPB expenses, or any other kind of expenses, it is difficult to see how this possibly could have been done in any other way. Nevertheless, the requirement that records 'identify the source and application of funds for federally-sponsored activities' was met: the source of the funds was RTL, CPB and PBS, and the application of the funds was exclusively PCAT1. The precise amount of each one of these component figures is easily derived from FRC's books.

OIG notes that, on the other hand, FRC *did* discretely account for NSF funds and costs. Of course, that is because the NSF grant was awarded on a *straightforward cost-reimbursement basis*, and included a *budget specifically identifying costs matching the grant*. Because of this, we were able to properly account to NSF.

<u>We disagree</u> that this is a noncompliance issue. If this level of financial reporting was required, the necessary and sufficient precondition would have been a budget showing line-item detail allocations to RTL, CPB and PBS. We would be happy to operate in this way in the future.

(b) Procurement

OIG asserts that FRC "did not comply with federal procurement regulations in awarding its negotiated fixed price PSA contract to 9 Story" without a written sole source justification.

OIG then cites a long list of federal procurement regulations in the PBS/CPB/RTL agreements (to which FRC is not a party). Presumably CPB and PBS applied all these procurement provisions to FRC and other producers before entering into an agreement with FRC for the production of "Peg + Cat", but we do not recall participating in the process.

OIG alleges that because "FRC did not document its procurement process, compete its fixed price contract, or include federal access provisions in its negotiated contract, it was noncompliant with the RTL provisions in the PBS/ CPB/RTL agreement and federal regulations. It did not provide the transparency necessary to support how it determined the fair and reasonableness of the contract price".

If an agreement (a) incorporates by reference the generality of federal provisions, but (b) in addition has an Exhibit detailing specifics for certain federal provisions, and (c) contains provisions in the body of the agreement concerning specific such matters, there are almost certainly going to be some conflicts between all three. There were. In such cases, we believe that the agreement is the governing document. Unfortunately, the agreement is silent on the matter.

Federal requirements for procurement offer an example of such a conflict. The simple fact is that the agreement *specifies, requires and approves* that the Canadian animation production is to be done by 9 Story (1.3). All procurement requirements are therefore voided by the provisions of the agreement itself.

It was of the essence of the agreement that US$8.2 million in animation services was being secured for US$5.2 million. This seems to be not merely 'fair and reasonable' but an absolute bargain. It is true, as OIG notes, that the reasonableness of the budget was consistent with FRC management's experience in animation production over 30 years, and that the detailed budget was approved by PBS which has an equally long experience of such matters.

(c) Flowdown provisions and Vendor access

OIG finds that FRC did not provide for CPB to have access to 9 Story's books in the Production Services Agreement, which it says is a requirement of federal procurement provisions. As we have pointed out, we do not believe that federal procurement provisions apply to this vendor. In drawing up the PSA, we followed OMB A-133 rules, which exclude both commercial and non-U.S. based vendors from such provisions. Furthermore, we have repeatedly noted that this was a fixed price contract, and to the extent that the actual costs incurred by 9 Story were under or over the budget, it would have made no difference whatever to FRC or the PTV Entity. We remain unclear why access to a vendor's books is relevant in such circumstances. <u>We disagree with all these noncompliance findings.</u>

(d) Award Monitoring (PCAT1)

The subaward by PBS and CPB to FRC for the production of PCAT1 covered a period of over three years, during which time FRC provided frequent (usually monthly) reports to PBS on the production, and during which time a team of staff at PBS including those responsible for RTL compliance joined monthly conference calls with FRC staff to discuss matters pertaining to the production. Many of the issues discussed here were rehearsed at length in these discussions. FRC is not aware of any aspect of the overall administration of this production that did not meet with PBS's approval.

All are agreed that these agreements are complex. We believe that the OIG report provides helpful observations for all parties on a number of issues, and look forward to working with PBS and CPB in the future to address them.

Sincerely,

Kevin Morrison

Kevin Morrison,
Chief Operating Officer

cc: Paul Siefken, President and CEO
cc: Debra Sanchez, SVP, Education and Children's Content Operations, CPB
cc : Jackie J. Livesay, Vice-President, Compliance, CPB