

MANAGEMENT LETTER

To the Board of Directors
Florida Institute for Human and Machine Cognition, Inc.
Pensacola, Florida

In planning and performing our audit of the financial statements of Florida Institute for Human and Machine Cognition, Inc. (the Institute) for the year ended June 30, 2005, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control.

However, during our audit, we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. This letter does not affect our report dated September 9, 2005, on the financial statements of the Institute.

We will review the status of these comments during our next audit engagement. We have already discussed many of these comments and suggestions with various Institute personnel, and we will be pleased to discuss these comments in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations. Our comments are summarized as follows:

Segregation of Duties

Auditor's comment:

Due to the small size of the Institute, there is a lack of segregation of duties among the staff. The lack of segregation creates instances in which one individual may perform both custodial and recording functions of certain assets. The basic premise of control is that no one employee should have access to both physical assets and related accounting records or to all phases of a transaction. We noted the following areas in which a lack of segregation of duties existed during the year ended June 30, 2005:

- Custody of signed checks before mailing is not handled by someone independent of all payable, disbursing, cash, receiving, and general ledger functions.
- Persons authorized to initiate banking transactions are not prohibited from having access to the accounting records.
- Personnel in the payables function are not independent of purchasing, disbursing, and general ledger functions.
- Persons preparing the payroll are not independent of other payroll duties (such as timekeeping, distribution of checks), and they have access to other payroll data and cash.

We suggest that management continue to review its internal control structure and segregate duties among its staff to the greatest extent possible. Individuals outside of accounting can be used to mitigate situations where incompatible duties exist.

Since 1944 • www.scg-cpa.com

Management's response:

The management of FIHMC recognizes that certain incompatible functions exist within the Organization due to the limited staffing of the accounting functions. It will begin to identify and integrate certain members of the management team into the accounting processes. It is anticipated that taking such a step will help to mitigate some of these incompatible functions.

Bank Account - Establishment and Closings

Auditor's comment:

During the audit, we noted no evidence of authorization by the Board of Directors for both the opening of the Gulf Coast Community Bank checking account as well as the closing of the Bank of Pensacola general operating account. Typically financial institutions require a resolution from the board for these transactions in order to prevent the opening of an unauthorized bank account which could be used to engage in fraudulent activity. Accordingly we recommend the board closely monitor this activity and provide the appropriate documentation in the minutes to support these transactions in the future.

Management's response:

In the future FIHMC will ensure that the Board of Directors is notified prior to opening or closing any bank accounts regardless of the dollar amount of the account. The powers and duties of the Chief Executive Officer (CEO) set forth in Section 1004.447 (7) (b), F.S. authorize financial decision-making by the CEO and at its initial meeting, the Board authorized the CEO to exercise that authority set forth in Section 1004.447. Due to the small size of the Pensacola community, the requirements of Chapter 112, F.S. that Directors abstain from voting on matters in which they have a conflict or business involvement, and the number of FIHMC Board members who are bankers or who sit on banking boards, it was acknowledged by the Board that these matters were more appropriately decided by staff and reported to the Board.

Vacation Policy

Auditor's comment:

The policy for payment of earned but unused vacation days is not well defined, documented, or communicated to employees. Specifically, we noted that supporting records were not adequate to track vacation days each employee took during the period. The result is the potential for misunderstandings and conflicts with current and terminating employees and the potential for the overpayment of accrued leave.

We recommend that a policy be established, communicated to existing employees, and included in the personnel manual. In addition, time or expense reports that salaried and hourly employees file should be revised to provide for recording vacation days taken in each pay period. Since the total number of employees is manageable, it should not be difficult to set up a schedule to track, by employee, vacation days earned, used, carried over (where approved), and expired. (Such a schedule could be easily maintained by computer.) The Institute might also find it desirable to periodically communicate to employees the status of their "vacation hours available." Many organizations include this information on the individual's pay stub.

Management's response:

While we are appreciative of these suggestions, FIHMC Personnel Policy 500, Benefits and Hours of Work addresses the FIHMC vacation policy and has been on line for employees since fall of 2004. A deliberate decision was made by the FIHMC leadership staff that vacation and sick leave (generically called Leave) should not begin until July 1, 2005 and this is reflected in Policy 500 on page 5 of the FIHMC policies. The reason for this decision was that many administrative people were transitioned in February of 2005 but research staff would not be transitioned until later in 2005. It was concluded that it would seem unfair to only provide leave to administrative people and that it would be more appropriate to wait until the majority of employees had transitioned into FIHMC. Therefore, leave was not provided during the period of this audit. As individual employees were transitioned into FIHMC, both the General Counsel and FIHMC Controller met individually with each employee and explained in great detail the FIHMC benefits package, including leave and accruals. Additionally, each employee has access to all FIHMC policies. FIHMC is currently in the process of implementing the leave policy as the majority of employees have now transitioned.

Revenue recognition procedures - CMAP contract

Auditor's comment:

Revenue on the CMAP contract is earned based on the completion of certain "milestones". We noted that there is not an established procedure for reporting when these milestones are met for purposes of accruing revenue earned by the Institute. We recommend that a policy be developed, with appropriate documentation, reflecting exactly when these events are accomplished to allow for appropriate accounting for this program.

Management's response:

In the future, the FIHMC procedure is that the Principal Investigator (P.I.) will document in writing and evidence completion of milestones to the Sponsored Research Executive prior to billing on a contract. In the past, these communications had occurred verbally in weekly Leadership Team meetings and in weekly meetings with the individual PI's. This procedure will be formalized in IHMC Policies and Procedures on the FIHMC website.

Contributed services

Auditor's comment:

During the period of transition between being a part of the University of West Florida and setting up the Institute as an independent non profit corporation, the Institute, received a significant amount of contributed services from the University of West Florida. The Institute initially had not tracked and recorded these contributed amounts although management was able to identify amounts related to these contributions. Subsequently these contributions have been recorded in the financial statements of the Institute in accordance with generally accepted accounting principles.

Management's response:

The accounting staff is aware of this comment and in the future will properly record these contributions in the books and records of the organization.

Fraud Risk Assessment

Auditor's comment:

We noted that the Institute has not developed a formal fraud risk assessment and monitoring program that is appropriate for the size and complexity of the Institute with the aim to identify specific fraud risks and to take appropriate action to reduce or eliminate the risks. Since the Institute has not developed its internal control system to include an appropriate system for segregation of duties, certain fraud risks may exist or may be created as business practices change in the future. We recommend that management schedule a periodic meeting to discuss the areas in which the Institute may be vulnerable to fraud and develop and implement processes to help mitigate these risks as they arise. We additionally recommend that the Board of Directors be advised of the Institute's current accounting procedures and be involved in the oversight of the Institute's fraud risk management program.

Management's response:

As previously discussed, the size of the organization precludes it from being free of all incompatible functions. Management recognizes that some risks are inherent in its operating environment and will develop a plan to address them. After addressing the risks, management will begin to identify the processes, controls, and other relevant procedures in order to mitigate those risks coming to its attention. Additionally it will communicate its procedures to the Board of Directors.

We wish to thank the Institute management and staff for their support and assistance during our audit.

This report is intended solely for the information and use of the Board of Directors and management, and is not intended to be and should not be used by anyone other than those specified parties.



Pensacola, Florida
September 9, 2005