

MINUTES OF THE FEBRUARY 18, 2014, AUDIT AND REVIEW COMMITTEE MEETING

The Audit and Review Committee (“the Committee”) of the Board of Regents of the Smithsonian Institution met on February 18, 2014. Participating were Committee Chair Robert Kogod and Committee members Representative Sam Johnson*, Barbara Barrett*, and Shirley Ann Jackson*, as well as Special Advisor to the Committee Herb Schulken. Committee member Senator Jack Reed was unable to participate.

Participating staff included Secretary G. Wayne Clough; Acting Inspector General Epin Christensen; Office of the Regents Senior Writer-Editor Barbara Feininger (recorder); Director of Finance and Accounting Jean Garvin; Assistant to Representative Johnson Dave Heil; Under Secretary for Finance and Administration and Chief Financial Officer Albert Horvath; Assistant to Senator Reed Moira Lenehan; General Counsel Judith Leonard; Office of the Inspector General (OIG) Supervisory Auditor Joan Mockeridge; Office of Government Relations Director Nell Payne; Office of Advancement Director of Operations and Systems Jerome Posatko; Interim Director of the Office of Finance and Accounting Hossein Sadid; and Chief of Staff to the Regents Porter N. Wilkinson. Also in attendance were Audit Partner Ellen Harrison and Audit Senior Manager Rennie Henry, who represented the Smithsonian’s external auditors, KPMG, LLP (“KPMG”).

CALL TO ORDER

Mr. Kogod called the meeting to order at 2:03 p.m.

APPROVAL OF THE MINUTES OF THE OCTOBER 10, 2013, COMMITTEE MEETING

Upon motion duly made and seconded, the draft minutes of the October 10, 2013, Committee meeting were approved without modification.

REVIEW OF FISCAL YEAR 2013 FINANCIAL STATEMENT AUDIT

Under Secretary Al Horvath reviewed the draft fiscal year 2013 financial statement audit, the results of which were similar to the fiscal year 2012 audit. The completion of the year-end closing process and financial statement audits went smoothly. Although the October 2013 Federal shutdown delayed this year’s closing by a few weeks, the team is positioned to complete future closings and audits by mid-January. Mr. Horvath recognized the contributions of Interim Director of the Office of Finance and Accounting Hossein Sadid.

Total assets in fiscal year 2013 increased by 6.6 percent, totaling over \$4 billion. Investments grew by \$148 million through a combination of new endowment gifts and market-value increases in the portfolio, which reflected a total return of 12.6 percent. Property and equipment increased by \$97.1 million due to construction and renovation activities, and receivables and advances increased by \$29.1 million.

Liabilities grew by 6.4 percent. This was primarily due to the Smithsonian's adoption of generally accepted accounting principles (GAAP), which call for the estimation and recording of conditional asset retirement obligations. Fiscal year 2013 environmental liabilities totaled \$69.2 million, which includes estimated costs for asbestos and lead paint remediation, as well as earthquake damage, in certain existing Federal facilities. The Smithsonian's November 2013 issuance of \$100 million dollars in new external debt was not reflected in the results. Total net assets increased by 6.6 percent to \$3.2 billion.

Operating revenues grew by \$33 million. Mr. Horvath noted that the Smithsonian's adoption of new treatment of actuarial liability for Federal workers' compensation benefits was reflected in the revenue and expense reports with no impact on net assets beginning in fiscal year 2013. Total revenues were essentially flat from fiscal year 2012 to fiscal year 2013.

Total operating expenses grew by \$51 million in fiscal year 2013, \$29.7 million of which include the imputed benefit costs associated with functional expense categories. Expenses increased less than 2 percent. Total net assets from operations increased by \$193.4 million. Major non-operating items included the recording of environmental remediation liability (\$69.2 million) and investment gain over the standard payout of \$76.6 million.

REVIEW OF KPMG'S FISCAL YEAR 2013 FINANCIAL AUDIT RESULTS AND MANAGEMENT LETTER

KPMG Audit Partner Ellen Harrison presented KPMG's audit results. The draft audited financial statements were included in the meeting materials, as well as KPMG's required communications and draft management letter comments. The management letter will be finalized and presented to the Committee at its next meeting.

The audit of Smithsonian-wide financial statements (Federal and Trust) is expected to result in an unmodified opinion. KPMG issued its audit report on the Federal closing package on December 17, 2013. The audit of the closing package of special-purpose financial statements for Federal Funds resulted in an unmodified opinion. That audit was completed in accordance with Department of Treasury and Office of Management and Budget requirements.

Ms. Harrison reviewed KPMG's required communications with the Committee. She discussed KPMG's responsibilities under professional standards; accounting practices and alternative treatments that are significant to the Smithsonian; and management judgments and accounting estimates. With the exception of recognizing environmental remediation obligations and imputed costs for actuarial liability for Federal workers' compensation benefits, there were no major changes in the Smithsonian's accounting policies in fiscal year 2013. KPMG agreed that the key factors and assumptions used by management in making accounting estimates and judgments significant to the financial statements were reasonable.

Audit adjustments and uncorrected audit differences were reviewed. One adjustment was

identified by KPMG and recorded by management. Mr. Horvath reported that the adjustment reflected the Smithsonian's transition from manual to automatic recording of certain assets. The process will become fully automatic in fiscal year 2014. KPMG concurred with management's determination that certain differences are immaterial.

KPMG Audit Senior Manager Rennie Henry reviewed other KPMG required communications to the Committee. He stated that communications were within the norm of audit engagements and said the Smithsonian cooperated fully with KPMG over the course of the audit. The only challenge to the audit was the Federal shutdown.

Ms. Harrison said the final management letter will note that no material weakness or significant deficiencies in controls were identified. The letter will include KPMG's observations and recommendations to strengthen certain control processes, including (1) enhancing documentation of gift revenues; (2) implementing procedures to prevent the netting of revenues against expenses; (3) strengthening year-end procedures; and (4) reviewing network access and data center access. Mr. Schulken said the management of the Smithsonian's gift revenues will continue to be challenging. Mr. Horvath noted that the Smithsonian's fundraising infrastructure is relatively young. Most gifts are based on standardized gift agreements but some are complex and require human interaction. Office of Advancement Director of Operations and Systems Jerome Posatko reported that the rollout of the pan-institutional database for Advancement (PANDA) has strengthened the documentation and management of gift agreements and revenue.

CHIEF FINANCIAL OFFICER'S UPDATE

The Secretary commented on Mr. Horvath's review and reorganization of the Smithsonian's financial systems since he joined the Institution. Prior to his arrival, said Mr. Horvath, the Smithsonian was remediating its internal controls. The implementation of an enterprise risk management program was formally launched in summer 2013 with support from outside consultant Booz Allen Hamilton (BAH). Over 70 leaders across the Smithsonian were interviewed; significant risks were inventoried and analyzed; the top 23 risks were identified; and a more formal infrastructure is being created to assess and manage risks going forward. Management anticipates that a detailed review of institutional risks and recommendations, a proposed infrastructure and implementation plan, and an evaluation process will be presented to the Committee its spring 2014 meeting.

The scope of the Smithsonian's integrated risk management program is broad, and will address current and future facilities and programs, as well as the Institution's expanded international footprint. Policies and procedures are being developed with the support of the Office of the General Counsel. The Audit and Review Committee will receive, at least, annual updates on the integrated risk management program. The Committee requested regular, in-depth reports on issues identified to be of highest risk, as well as updates on management's efforts to remediate such risks.

Mr. Horvath discussed BAH's report on cash operation improvements, which was undertaken in response to the theft of parking fees at the Udvar-Hazy Center. All of BAH's recommendations have been implemented successfully. A required training program for revenue-generating contracts has been developed and implemented. KPMG was retained to conduct special audits of five major Smithsonian major vendors that handle significant amounts of cash. No significant issues were identified with three of the five vendors. Although no significant issues were found at most locations for one vendor, the scope of its audit is being extended, the results of which will be presented to the Committee at its next meeting. The fifth vendor is working with management to ensure that all identified issues are addressed.

UPDATE ON THE PAN-INSTITUTIONAL DATABASE FOR ADVANCEMENT

Mr. Posatko updated the Committee on the implementation of PANDA. With the deployment of PANDA, the Smithsonian successfully completed governance reform recommendation 23, which identified areas of high-level risk in how the Smithsonian recorded its charitable contributions. The Smithsonian has standardized the processing and coding of contributions; restructured the reconciliation process between different financial management systems; and updated gift policies and procedures. PANDA is now the central donor database of record. It supports a new single-process flow of gift documentation, as well as centralizes gift receipting. The new development IT infrastructure automatically interfaces with the Smithsonian's ERP system, and the implementation of a Financial Self-Service module has reduced unit workloads. The system supports all membership programs; robust and secure end-use access; and business intelligence tools for campaign reports, data analysis, and dashboards. Phase II of the PANDA rollout will include bringing 13 units with standalone files into the PANDA system; improving the quality of data; centralizing all membership programs; and building out production reports and analytics.

ACTING INSPECTOR GENERAL'S UPDATE

Acting Inspector General Epin Christensen discussed OIG reports completed since the last meeting of the Committee: "Top Management Challenges for 2013"; Smithsonian Tropical Research Institute (STRI) Financial Operations"; and "Financial Statement Assurance Letter Process." The Smithsonian's top management challenges include the Federal budget and sequestration; safety and security of staff and visiting public; collections stewardship; construction management; and information security. The OIG works to identify cost savings and more efficient uses of the Smithsonian's limited resources, as well as monitor increased risk factors that may result from budgetary restraints. The OIG will audit the management of facilities security and emergency preparedness, including reviewing the Office of Protective Services' 2012 risk assessment of all Smithsonian facilities.

The report on STRI's financial operations resulted in 12 recommendations. Closure requests have been received for six of the recommendations, one has been extended, and five are not yet due. The audit report "Financial Statement Assurance Letter Process" revealed that unit directors generally have an effective process to support the annual requirement to attest to the

effectiveness of their units' financial reporting controls and financial information reliability.

Ms. Christensen reviewed six ongoing OIG audits. The motor vehicle fleet operations audit is nearly complete, and will recommend a tightening of procedures and reconciliation of data discrepancies. The audit of the purchase card program also is nearly complete and largely positive; the audit will recommend the tightening of policies, codes, and procedures.

The OIG has completed the fieldwork for its audit of the management of leased office space; is in the fieldwork stage of the pan-institutional approach to collections care initiatives; and is in the report-writing phase of the audit of the information security program. Ms. Christensen discussed the proactive continuous audit program, which performs automated and semi-automated ongoing control and risk assessments.

Two potential audits are under consideration: a preliminary inquiry into the National Zoological Park and an assessment of facilities security and emergency preparedness.

Ms. Christensen reported that the Smithsonian is making positive progress in the closing down of audit recommendations. At the time of this meeting, there were only three past-due recommendations.

Ms. Christensen noted that the Smithsonian's Office of the Inspector General is small relative to many other organizations. She commented on the quality of the relationship between Smithsonian management and the OIG, and the mutual understanding of their respective roles and responsibilities.

EXECUTIVE SESSION

The Committee adjourned its open session at 3:46 p.m. to conduct executive sessions with KPMG, the Chief Financial Officer, and the Inspector General, followed by a member-only session. The meeting was adjourned at approximately 4:15 p.m.

Respectfully submitted,
Robert Kogod, Chair