MINUTES OF THE APRIL 16, 2012, AUDIT AND REVIEW COMMITTEE MEETING

On April 16, 2012, the Audit and Review Committee ("the Committee") met in the Regents' Room of the Smithsonian Castle. Participating were Committee Chair John McCarter* and Committee members Representative Sam Johnson* and Robert Kogod. Committee members Senator Jack Reed and Shirley Ann Jackson and Special Advisor to the Committee Herb Schulken were unable to participate.

Participating staff included Secretary G. Wayne Clough; Chief of Staff to the Secretary Patricia Bartlett; Inspector General Scott Dahl; Assistant to Representative Johnson David Heil; Under Secretary for Finance and Administration and Chief Financial Officer Albert Horvath; Chief of Staff to the Regents John K. Lapiana; General Counsel Judith Leonard; Assistant to Senator Reed Moira Lenehan; Director of Government Relations Nell Payne; and Comptroller Andrew Zino. Also in attendance were Joanna Friedman, Ellen Harrison, and Wendy Lewis, who represented the Smithsonian's external auditors, KPMG LLP ("KPMG").

Mr. McCarter called the meeting to order at 2:10 p.m.

Because a quorum was not present at the beginning of the meeting, Mr. McCarter rearranged the agenda.

STATUS OF THE FISCAL YEAR 2011 FINANCIAL STATEMENT AUDIT RESULTS AND MANAGEMENT LETTER

Mr. Zino directed the Committee to materials on the fiscal year 2011 financial statement audit results and management letter, including his summary. Pointing to the summary of the statement of financial position, Mr. Zino noted that, among other highlights, fiscal year 2011 ended with cash balances with the United States Treasury up by $66.4 million and net investments in property and equipment up by $62.9 million. Investments ended the year down approximately $40.3 million due to market declines and the annual payout.

Total liabilities increased by less than $1 million, or less than 1 percent. He added that total net assets increased by $100 million, or 3.7 percent.

With regard to the audit's statement of financial activity, Mr. Zino directed the Committee to the statements on business activities and short-term investment income, which decreased by $6.8 million (4 percent) and $3 million (68 percent), respectively. He explained that the latter was due to the low return on the Smithsonian's short-term portfolio (i.e., extremely low interest rates).

Mr. Zino said that a new category was added to the financial statements to reflect the change in value of the Smithsonian's minority interest in Smithsonian Networks. He said that the Smithsonian was obligated to use the equity method of accounting because of its increased ownership interest.

** participated by teleconference*

With regard to the statement of cash flows, Mr. Zino explained that the cash flows from financing activities fell to $172.2 million, a decline of $14.4 million from fiscal year 2010. The decrease was attributable to a particularly successful fundraising year for the Endowment in fiscal year 2010.

KPMG REPORT ON FISCAL YEAR 2011 FINANCIAL STATEMENT AUDIT AND MANAGEMENT LETTER

KPMG Senior Partner Ellen Harrison began KPMG's presentation on the fiscal year 2011 audit results and management letter. She noted that KMPG issued the audit on February 24, 2012. Ms. Harrison characterized it as "an unqualified, clean audit report" and said that KMPG did not need to significantly deviate from the audit plan presented to the Committee in September 2011. She said that management "made significant progress in 2011 as it relates to financial reporting." KMPG found no significant deficiencies or materials weaknesses in Smithsonian internal controls.

Ms. Lewis then presented KPMG's "required communications" with regard to the firm's responsibility under professional standards. She noted that KPMG found no instances of fraud or other illegal activity. The Committee was directed to the meeting materials for KPMG's communications on accounting practices and alternative treatments; management judgments and accounting estimates.

With regard to audit adjustments (e.g., a reclassification of net assets which did not "affect the bottom line") and uncorrected audit differences, Ms. Lewis said that both KPMG and the Smithsonian agreed that the four differences identified were immaterial and added that the audit letter more fully explained the differences. Ms. Lewis also observed that management was cooperative in supporting the KPMG review, providing full access to the Smithsonian's books and records.

Ms. Friedman highlighted the key elements of the management letter. She noted that no material weakness or significant deficiencies were noted, although KMPG did make observations regarding contributions receivable accounting (instance of double-counting of a pledge and use of different discount rate methodologies by units), operating expenses (accrual/cut-off issues), and information technology access (access by former employees to the PeopleSoft system). Ms. Friedman noted that KMPG's prior comments were all "substantially addressed or resolved during 2011."

With regard to the KPMG financial observations on contributions receivable accounting, Mr. Zino responded that a manual process has been put into place to record contributions to ensure against double-counting and that the Offices of the Comptroller and the Treasurer will work together to establish a pan-institutional discount rate application for pledges. Another process has been developed and will be implemented to avoid the accrual/cut-off date issues identified by KPMG. Finally, Mr. Zino noted that the Office of the Chief Information Officer has implemented a new safeguard that will prevent access to Smithsonian web-based systems (e.g., PeopleSoft) as an employee goes through the exit clearance process.

APPROVAL OF THE JANUARY 19, 2012, COMMITTEE MEETING MINUTES

Mr. McCarter noted that a quorum had been achieved since the meeting began and asked that the January 19, 2012, committee meeting minutes be approved. The draft minutes were approved without modification.

EXECUTIVE SESSION

The Committee conducted an executive session with KPMG, after which Ms. Friedman, Ms. Harriman, and Ms. Lewis departed.

REPORT OF THE INSPECTOR GENERAL

Mr. Dahl said that he has shared his desire with KMPG to move up the completion date for the fiscal year 2012 audit to January 2013. Mr. Horvath added that management was committed to a more timely completion of the audit.

With KPMG's departure, Mr. Dahl presented a motion to support a one-year extension of the KPMG contract for auditing services. The Committee asked the Inspector General for additional pricing information. The Committee then briefly reviewed the contracting process for auditing services and the prescriptions and guidance of the Sarbanes-Oxley Act. With the Committee's comments in mind, the Inspector General was authorized to extend the current auditing services contract with KPMG for an additional year.

At Mr. Kogod's suggestion, Mr. McCarter asked management to review the steps the Smithsonian originally implemented in light of the Sarbanes-Oxley Act and to consider whether any modifications are appropriate.

Mr. Dahl then briefly reported on the status of his office's current audit activities and priorities, particularly the review of travel at the non-senior staff, senior staff, and Regent levels.

Mr. McCarter directed members' attention to the memorandum in the materials entitled "Working Relationship Principles for Management and the Office of Inspector General." He expressed his endorsement, shared by the Committee, that the principles cited in the document will promote a more productive relationship between the Office of the Inspector General and management.

UPDATE ON SMITHSONIAN INSURANCE COVERAGE

Mr. Anand provided the annual Committee briefing on insurance. He began by noting that the Smithsonian's privately purchased insurance program is built around the protections already provided by the Federal Government (e.g., self-insurance, Federal Tort Claims Act, sovereign immunity). Mr. Anand then reviewed the three classes of policies the Smithsonian purchases—property, liability, and special purposes—and the insurance carriers with which the Smithsonian currently does business.

In response to a question by Dr. Clough, Mr. Anand explained the coverage triggered, and gaps identified, by the August 23, 2011, earthquake. He noted that only one Trust-funded property, a building at the Smithsonian Environmental Research Center, suffered damage and that it was covered by private insurance. Mr. Anand said that, to date, no other Smithsonian units have presented claims for earthquake damages.

Mr. Anand then highlighted the results of a benchmarking analysis of Smithsonian insurance coverage as compared with other certain similar organizations (e.g., museums and public universities).

UNDER SECRETARY'S REPORT ON INTERNAL CONTROLS

Mr. Horvath updated members on the status of efforts to address deficiencies in 23 financial and administrative process identified in a 2008 internal controls assessment. He said that progress has been made in all areas and focused briefly on accomplishments in the implementation of a new ERP system; revisions of Smithsonian Directives, handbooks, and policy/procedures; and the development and expansion of compliance review programs. Mr. Horvath added that he was very impressed with the level of attention staff devotes to improving internal controls.

He identified two areas where he expects that progress will accelerate in the next two years. He predicted that personal property and management and procurement will be upgraded to "green" by the end of fiscal year2012 and that charitable contributions management will achieve that status in fiscal year 2013.

In summary, he said, the staff team overseeing the internal controls effort has "been successful." Moving forward, a key area of emphasis will be on educating staff on the importance of continued vigilance and answering questions on how internal controls should impact their day-to-day activities. Mr. Horvath anticipated that, as the financial and administrative control implementation process is completed, his focus will likely turn more to information technology controls and other operational issues to ensure the same level of accountability and monitoring is in place to assess and measure risk as in the financial areas.

EXECUTIVE SESSION

The Committee then conducted an executive session.

The meeting was adjourned at approximately 3:35 p.m. with the Committee conducting an executive session.

Respectfully submitted,

John McCarter, Chair