MINUTES OF THE MARCH 6, 2009, AUDIT AND REVIEW COMMITTEE MEETING

On March 6, 2009, the Regents' Audit and Review Committee ("the Committee") met at 3:00 p.m. in the Regents' Room of the Smithsonian Castle. Participating were Committee Chair John McCarter* and members Shirley Ann Jackson*, Congressman Sam Johnson*, and Robert Kogod. Also participating were Assistant to Congressman Johnson David Heil*, Committee Advisor Herb Schulken*, and, representing the Institution's auditors KPMG LLP, Ellen Harrison*, Rebecca Horton, John Keenan, and Liz Lawson*. Participating staff included Secretary G. Wayne Clough, Treasurer Sudeep Anand, Chief of Staff to the Secretary Patricia Bartlett, Smithsonian Enterprises (SE) Chief Financial Officer (CFO) Greg Bokman, Systems Modernization Director Deron Burba*, SE Comptroller Beth Cunigan, Office of the Inspector General Financial Audit Manager Bruce Gallus, Associate General Counsel Lauryn Guttenplan, Office of the Regents Program Officer Grace Jaeger, Chief of Staff to the Board of Regents John K. Lapiana, CFO Alice Maroni, Under Secretary for Finance and Administration Alison McNally, Inspector General (IG) Sprightley Ryan, Deputy Comptroller Stella Whitsell, and Comptroller Andy Zino. Minutes were taken by Susan Block, Special Assistant to the CFO.

Committee Chair John McCarter opened the meeting.

Review of the Fiscal Year 2008 Final Audited Financial Statements

Comptroller Andrew Zino informed the Committee that the fiscal year 2008 audit was completed on time (and in 15 fewer days than the fiscal year 2007 audit), the Institution received an unqualified audit opinion, and there were no material weaknesses. He reported that there was a 67 percent drop in the number of uncorrected audit differences and an 80 percent reduction in the number of corrected audit differences during the fiscal year 2008 audit. He told the Committee that KPMG had identified three "significant deficiencies" along with two additional items noted as "other observations." This was a "material drop" of almost 60 percent in the number of "significant deficiencies" over the prior year and a 33 percent drop in the number of "other observations." He told the Committee that management had responded to each of the comments and KPMG had indicated that they were satisfied with management's response. With respect to the prior year's comments, eight had been satisfactorily resolved, one had been substantially resolved, and four were "in process" towards resolution. He informed the Committee of five changes that were made to the draft financial statements on which he reported at the January 2009 Committee meeting. He concluded that it had been a very successful audit season and that he believed that both KPMG and the Inspector General would agree with that assessment.

The Chair requested that the Comptroller send the Committee his talking points so that it could review the changes discussed between the draft and final statements. The Comptroller agreed to do that.

** participated by teleconference*

Review of Fiscal Year 2008 KPMG Management Letter and Required Communications Letter

KPMG Senior Partner John Keenan informed the Committee that great progress was made in the past year and that he agreed with Mr. Zino's assessment. He then turned the meeting over to Rebecca Horton to discuss the Management Letter.

Ms. Horton informed the Committee that the Management Letter identified three "significant deficiencies" and two "other observations." The first "significant deficiency" was related to contribution accounting. KPMG found that the Smithsonian had not established a formal process to document its evaluation of the possible accounting implications of changes in payments or other terms of significant donor agreements.

The Committee discussed how to fix this problem and ensure that it would not be reported next year as a significant deficiency. It was reported that the Office of Comptroller (OC) and the Office of Development (OD) were working to address this issue but that the decentralized nature of the Smithsonian process presented difficulties. The Secretary informed the Committee that, although the Institution did not have the systems necessary to fix this problem, a better job could be done with the systems currently in place.

The second "significant deficiency" was related to construction activities. Ms. Horton informed the Committee that the Smithsonian's accounting for project costs was a manual process, and that substantial year-end effort was required to ensure that construction-related items were properly recorded. During KPMG's review of construction-in-progress accounts and associated year-end accruals, several errors were discovered.

The Comptroller said that the implementation of the Project ID module (which is designed to track project costs) in the *PeopleSoft* financial system would correct this problem. In response to a question about the module's deployment schedule, he said that full implementation, including training, would be completed in fiscal year 2010 and Systems Modernization Director Deron Burba agreed. The Comptroller told the Committee that his office was already working on a interim solution to address this issue, pending the implementation of the Project ID module. Ms. Horton stated that the interim steps being taken by the Office of the Comptroller should be enough to keep this from being a significant deficiency next year.

The third "significant deficiency" was related to restricted net assets. Ms. Horton informed the Committee that the Smithsonian had made substantial progress during fiscal year 2008 in the reconciliation and analysis of its temporarily restricted net asset (TRNA) accounts and the related releases from restrictions. However, KPMG noted that procedures for identifying temporarily restricted net assets for facilities had captured only the outstanding balances on related pledges and did not identify outright gifts or payments received on construction pledges for projects not yet placed in service (and therefore should remain classified as TRNA).

The Comptroller told the Committee that he had met with the Office of Facilities Engineering and Operations (OFEO) and put in place an improved communications process. He said that the process would keep the OC informed, which should resolve this deficiency until a technological solution could be put in place.

Congressman Johnson asked KPMG why the Institution's return of $4.2 million to the U.S. Treasury last year had not been reported as a significant deficiency. He told the Committee that he thought that members needed to be aware of this situation and said that, considering how the Smithsonian was strained for resources, it was difficult to explain to Congress why the Smithsonian did not use all of its obligated funds.

The CFO stated that her office was well aware of this problem and had been working diligently to make sure that units deobligate their unused funds so that other units could use them. She explained that prior year funds in an expired status were required by law to be canceled. She stated that at a meeting of the senior Smithsonian finance staff on March 5, 2009, she and the Comptroller had stressed the importance of managing the amounts that are put on contract in the current year and the amounts that remain on prior year contracts. She stated that she would prepare an information paper on this subject for the Committee as it was an arcane issue that dated to 2003. Secretary Clough agreed to look closely at this issue.

The first "other observation" identified by KPMG was related to year-end expense accruals. KPMG noted that the Smithsonian did not have a process in place to both track prior year invoices received after cut-off dates(s) and to evaluate their total impact on the Institution's financial statements.

The second "other observation" was related to accounting practices for the Office of Sponsored Projects. During fiscal year 2008, the Office of Sponsored Projects implemented a new billing and receivables module to track and bill both private and Federal grants. Based on KPMG's review of selected items that were input into the new system, it did not appear that the data between the former and current systems had been fully reconciled.

Ms. Horton informed the Committee that Attachment II of the Management Letter was a summary of and status report on prior year comments.

In response to a question from the Chair, Mr. Burba said that the implementation costs for the Institution's *PeopleSoft* financial system would total about $70–$75 million and included expenditures for hardware, software, human resources modules, operations, and the day-to-day running of the system. Mr. Burba said that three modules still needed to be implemented: cash management, project costing, and grants and contracts. He added that, because the Smithsonian already owned those modules, their cost would be limited to $2–3 million in implementation expenses. The CFO told the Committee that an additional module for budgets still needed to be implemented but that the Institution had not found one that met the Institution's needs. She also noted that the system implementation costs were multi-year totals from fiscal year 2001 to the present.

Mr. Keenan then discussed the required communications letter to the Committee. He stated that, in accordance with SAS 114, a formal letter to the Committee and the Inspector General was required. Mr. Keenan informed the Committee that KPMG had received excellent cooperation from management and that all deadlines had been met.

Review of Fiscal Year 2008 KPMG Report on Smithsonian Enterprises' Statement of "Net Gains," Management Letter, and Required Communications Letter

Mr. Keenan then introduced Liz Lawson, who thanked SE Chief Financial Officer Greg Bokman and SE Comptroller Beth Cunigan for their assistance in the separate audit of SE's statement of "net gains" for fiscal year 2008. This audit was requested by the IG because senior SE officials' bonuses are based on net gain. Ms. Lawson told the Committee that KPMG had issued a qualified opinion on the special purpose statement of "net gain" because KPMG had not been present to observe SE establish its opening physical inventory balance for fiscal year 2008, and had performed only limited other audit procedures regarding inventory quantities prior to the start of fiscal year 2008. She stated that KPMG found no material weaknesses while performing their review. Three "significant deficiencies" and one "other matters and recommendations" were reported.

The first "significant deficiency" related to system access. It was noted that Smithsonian Enterprises utilized the Lawson system for general ledger accounting and the Island Pacific system for inventory. KPMG identified several access control matters in these systems.

The Chair asked Mr. Bokman how SE would achieve the correct segregation of duties, and he responded that SE had inserted a manager in the process who would be responsible for all changes to the production environments.

The second "significant deficiency" related to inventory and sales returns reserves. KPMG noted that management had not performed a formal analysis to determine whether inventory items were being sold below cost. KPMG also noted that management did not have a formal policy to address reserves for excess and obsolete store inventory. KPMG also noted that management did not have a formal policy to develop and record estimates for sales returns at year-end.

The third "significant deficiency" related to deferred promotion costs. KPMG noted that management had not prepared a reconciliation of total general ledger costs by campaign to the total costs that were being amortized. Ms. Lawson noted that SE had implemented a plan to address this problem.

Mr. Kogod reminded the Committee that the advisory board of SE's predecessor, Smithsonian Business Ventures, previously had performed oversight duties of that unit. He said that since the dissolution of that Board, SE reported to the Finance Committee and to the Audit and Review Committee for its audit. He stated that it should be determined if this was the correct amount of oversight.

Ms. Lawson then discussed the required communication letter to the Committee. She stated that KPMG was comfortable with SE's evaluation of its inventory and did not identify any significant difficulties, other than not witnessing the establishment of the opening inventory balance for the audit.

Inspector General's Report on the Oversight of the KPMG Audit

Inspector General Sprightley Ryan informed the Committee that shortly before the meeting she had e-mailed the Committee a letter stating that the audit had gone well, that timelines had improved, that "significant deficiencies" had decreased considerably, and that the overall audit process went much better for the fiscal year 2008 year audit.

The meeting adjourned at 3:25 p.m. The Committee then conducted three separate executive sessions with KPMG, the IG, and the CFO, after which it met alone.