MINUTES OF THE JANUARY 23, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On January 23, 2008, the Regents' Audit and Review Committee ("the Committee") met at 2:00 p.m. in the Regents' Room in the Smithsonian Castle. Committee members in attendance were Acting Chair Robert Kogod, Don Chapin, and Roger Sant. Patricia Stonesifer participated by telephone. Staff present at the meeting were Acting Secretary Cristián Samper; Acting Under Secretary for Finance and Administration Alison McNally; Chief Financial Officer (CFO) Alice Maroni; Treasurer Sudeep Anand; Director of Investments Amy Chen; Associate General Counsel Lauryn Guttenplan; General Counsel John Huerta; Chief of Staff to the Board of Regents John Lapiana; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; Chief Information Officer Ann Speyer; National Collections Coordinator William Tompkins; and Comptroller Andrew Zino. Also in attendance were John Keenan, Ellen Harrison, and Rebecca Horton, who represented the Institution's auditors, KPMG LLP. Minutes were taken by Susan Block, special assistant to the CFO.

Acting Chair Robert Kogod opened the meeting and asked for approval of the September 4 and October 2, 2007, minutes. A motion was made and seconded and the minutes were approved. Mr. Kogod then welcomed and introduced new member Don Chapin to the Committee and asked everyone present to introduce themselves.

KPMG Fiscal Year 2007 Financial Statement Audit

Mr. Keenan, senior partner with KPMG LLP, told the Committee that the audit of the "closing package" special-purpose financial statements for Federal funds had been completed in accordance with Department of Treasury and Office of Management and Budget (OMB) requirements. He reported that KPMG had issued an unqualified opinion on the fiscal year 2007 special-purpose financial statements. With respect to the fiscal year 2007 financial statement audit, Mr. Keenan advised the Committee that the work was proceeding substantially in accordance with the audit plan presented at the Committee's September 2007 meeting and that KPMG's focus was on non-routine transactions; key accounting estimates; and financial reporting and disclosure. He noted that final completion of the financial statement audit was scheduled for February 15, 2008.

Mr. Keenan then informed the Committee of an infraction of the Committee Charter of which he recently had become aware. The Charter requires that the Committee approve in advance any non-audit work proposed to be performed by the Institution's external auditors. A recent engagement of KPMG's Panama office by the Smithsonian Tropical Research Institute (STRI) to provide advisory services relating to a redesign of STRI's compensation system did not get flagged for approval prior to the engagement as it should have been. Mr. Keenan noted that KPMG has a service approval and conflict check system that it uses globally. He reported that Smithsonian was erroneously removed from the audit client list in this system while reconfiguration work for KPMG's Federal clients was performed during the summer of 2007, and that the error was not detected. As a result, Mr. Keenan was not properly notified of the proposed STRI engagement and was unable to request the Committee's approval. Mr. Keenan advised the Committee that the KPMG system error had been corrected and that the work done for STRI was permitted under the independence rules.

In response to a question from Mr. Kogod, Mr. Keenan assured the Committee that the infraction was the result of human error and would not pose any negative implications. General Counsel John Huerta reminded the Committee that, as a general practice and in the interest of maintaining the external auditor's independence, the Institution's external auditor should not be engaged to perform non-audit work. Mr. Kogod encouraged Mr. Keenan to ensure that this situation will not recur.

Mr. Keenan then introduced Ms. Harrison, who reported on KPMG's required communications to the Committee on the audit of the Federal "closing package" financial statements filed with the Department of Treasury and the Office of Management and Budget (OMB). She reported that KPMG evaluated the key factors and assumptions used by management related to actuarial liability for workers' compensation claims and useful lives of depreciable assets and concluded that each appeared reasonable. She reported on the adjustments recorded during the audit of the special-purpose statements and on the unrecorded audit differences that were determined by management to be immaterial. She noted that, to the best of KPMG's knowledge, there had been no consultation with other independent accountants.

Ms. Harrison then introduced Ms. Horton who discussed the recommendations made as a result of the closing package audit. Ms. Horton reminded the Committee that, under Statement on Auditing Standards No. 112 *Communicating Internal Control Related Matters Identified in an Audit*, which was applied to the Smithsonian for the first time in fiscal year 2007, the new reportable matters category "significant deficiency" has a lower reporting threshold than was used in the past. She stated that the accounting staff shortage in the Office of Comptroller was a factor in the recorded adjustments and unrecorded differences noted in the audit and that KPMG duly noted it as a "significant deficiency" in their audit report in the closing package. With respect to the financial statement audit, Ms. Horton reported that no material weakness has been noted to date. She stated that at the conclusion of the audit KPMG will prepare a letter to the Committee to communicate all deficiencies noted in the fiscal year 2007 audit and would update its comments and recommendations on the two reportable conditions identified during the fiscal year 2006 financial statement audit (accounting resources and staff capacity and valuation of nonmarketable investments). She indicated that the Institution's process for monitoring and documentation of the valuation of nonmarketable investments had improved substantially in fiscal year 2007.

In discussion, Mr. Kogod was assured that the Institution had resolved the definitional issues that had led to confusion during the fiscal year 2006 audit about the proper categorization of the Institution's investment portfolio in the financial statements. In response to a question, Mr. Chapin was told that the Smithsonian had no exposure to securities invested in subprime mortgages. Director of Investments Amy Chen noted that prior to the current subprime lending crisis the Institution moved an investment in one money market fund where there had been a limited exposure.

Comptroller Andrew Zino then led a review of the Institution's draft financial statements for fiscal year 2007. With regard to the financial position, he reported that total assets increased $242.1 million (8.4%). The major increases were in investments ($125.3 million), due to the strong performance of the Endowment, and cash and balances with U.S. Treasury ($54.8 million), due to a higher level of short-term investments. Gross additions to property and equipment during the year were $157.5 million, which were offset by approximately $97.8 million in depreciation charges, as well as additional reductions for retirements and disposals of $3.7 million. He informed the Committee that total liabilities increased $21.8 million (3.7%), primarily due to an increase in accounts payable and accrued expenses balances and unexpended Federal appropriations due to timing. Net total assets increased $220.3 million.

With regard to financial activity, Mr. Zino reported that total operating revenues increased $16.4 million (1.4%) compared to fiscal year 2006. Government revenue decreased $27.3 million (4.2%) due primarily to the effects of the late Federal appropriation during the first two quarters of fiscal year 2007. This decrease was largely offset by higher contributions and private grants of $37.8 million. He noted that total expenses remained basically flat in fiscal year 2007. Non-operating items included the recognition of the current portion of the gain on sale from the Victor Building ($4.2 million), an $82.2 million increase in investment income (to $120.0 million), and $11.9 million expended for the purchase of collection items.

With regard to cash flow, he reported that operating activities provided cash of $27.7 million in fiscal year 2007, compared to $49.5 million in fiscal year 2006. The level of cash from operating activities is affected by operating results and the timing of the receipt of revenues, particularly contributions, and the payment of expenses. He noted that cash used by investing activities was $145.0 million in fiscal year 2007, compared to $46.5 million in fiscal year 2006. The increase in cash used by investing activities is due primarily to the decrease in proceeds from sales of properties ($165.4 million), partially offset by a decrease in the use of funds for the purchases of property and equipment ($33.2 million), and a change in net purchases and sales of investment securities ($36.8 million). Cash provided by financing activities was $172.1 million in fiscal year 2007 and $54.3 million in fiscal year 2006. The increase in cash from financing activities is due primarily to a decrease in debt repayments ($88.0 million) as a result of early extinguishment of the Series 2000 Revenue Bonds in fiscal year 2006 and increased contributions for construction of facilities ($27.3 million).

Mr. Zino informed the Committee that there were no significant changes in the notes to financial statements in fiscal year 2007 as the adoption of one new accounting standard had only a minor effect on the Institution. He said that Note 6 provides new descriptions on the detail of all investments, including the nonmarketable investments, and that Note 11 provides disclosure of the effects of the implementation of Statement of Financial Accounting Standards 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

Chief Financial Officer Alice Maroni informed the Committee that she intends to convene an out-of-cycle meeting in February 2008 to discuss the financial statements, after KPMG has completed their work.

Mr. Sant asked why expenses for research were down by $30 million. Mr. Zino replied that it was due primarily to the correction of an error in expenses at the Smithsonian Astrophysical Observatory (SAO) as well as delays in SAO spending, grant cycles, and other SAO-related issues. In addition, he agreed to prepare an analysis of research expenses for the February 2008 meeting.

Mr. Chapin indicated that he had several questions and passed out a list. He first asked about what was being done to correct system vulnerabilities identified in the Inspector General's recent report. That report described the annual process for complying with the Federal Information Security Management Act of 2002 (FISMA) but noted that the Inspector General does not examine system-specific problems. Chief Information Officer Ann Speyer noted that the most recent IG FISMA report contains four findings, two of which pertain to minor systems not related to the Institution's financial system, collection systems, or human resources management system and that the IG's issues have been addressed. Inspector General Sprightley Ryan offered to make the report available to anyone interested. Mr. Keenan indicated that KPMG would review the report and report back if there were issues.

Mr. Chapin then observed that the Smithsonian is authorized by OMB to prepare nonprofit financial statements. He said that, when defining "Qualitative Materiality," the American Institute of Certified Public Accountants Audit Guide for nonprofits suggests that negative events involving relatively small amounts can be material if they result in limiting fund raising. He asked, in view of this definition, whether fund-raising disclosures were adequate. Mr. Keenan noted that KPMG did assess the qualitative materiality of all misstatements noted in its audits and that the evaluation focused on the potential implications to the organization. Ms. Harrison gave the allocation of expenses between program and supporting activities to achieve desired ratios as an example of an area where qualitative materiality is considered in a nonprofit audit. Mr. Chapin then asked how the auditors consider the application of qualitative materiality to the Institution's deferred maintenance issues. Mr. Keenan noted that Mr. Chapin's questions on these subjects were technical and that he was not fully prepared to get into an in-depth discussion about them at the meeting but that responses to Mr. Chapin's concerns would be provided. Mr. Chapin agreed to this.

Mr. Chapin then asked about KPMG's responsibilities with respect to the Institution's collections. Mr. Keenan reminded the Committee that KPMG takes no responsibility for the Institution's collections since their valuation is not on the books. The IG reminded the Committee that her office had done several reports on the collections and had made recommendations that the units are implementing. She noted that, according to Smithsonian policy, collecting units are responsible for conducting cyclical inventories of collections and reporting loss or damage to the Office of Protection Services (OPS) and the Treasurer's Risk Management Division. The Acting Secretary noted that, while not perfect, unit asset and inventory controls have been found by IG audits to be pretty good. He invited Mr. Chapin to do a behind-the-scenes tour of the collections.

Ms. Stonesifer recalled that every new Committee member has this question about the collections. She expressed an interest in a collection status checklist, not as part of the financial statements but in support of the internal audit process. She raised the issue of the Regents' responsibility for oversight of the collections and inquired about best practices among other museums. The National Collections Coordinator reminded the Committee that the collections are not a capitalized asset. He noted that OPS periodically undertakes a security and facility risk assessment, and that the museum accreditation process conducted by the American Association of Museums has strict collections security and inventory control requirements.

Proposed Amendments to the Committee Charter

The Committee considered a number of amendments to its charter. Inspector General Ryan proposed and the Committee agreed to delete the clause that indicates that the IG's performance will be evaluated by the Committee. It was acknowledged that IG performance evaluations involving clients are not the norm in the IG community. The IG noted that her performance is evaluated every three years by a peer IG organization. The Committee also agreed to add language to indicate that the Committee chair will transmit the IG's semiannual report to the Congress. Ms. Maroni offered and the Committee approved a series of technical amendments to conform the charter to the charter template that the Regents approved in November 2007. An amendment to establish a dollar threshold for the pre-approval of non-audit services to be performed by the Institution's external auditor was not adopted.

Inspector General's Update

Inspector General Ryan reported that her office had completed its peer review of the Federal Trade Commission's Office of Inspector General. She also said that her office had issued three investigative memos on management issues that were identified during the course of ongoing Smithsonian investigations. These management issues included a lack of training on the Institution's standards of conduct, the lack of a policy regarding the discipline of executives, and the lack of a requirement to document such disciplinary actions. Furthermore, they discovered a gap in the policy pro bono work for the Institution. Specifically, donated services valued at under $50,000 are not currently required to be documented. Management indicated its intention to address all these concerns.

Ms. Ryan informed the Committee that her office had issued a formal draft audit report on Smithsonian Business Ventures (SBV) contractor oversight, which was found generally to be adequate. She said that Cotton & Company LLP continues its review of the expenses of the former Secretary and the former CEO of SBV for fiscal years 2006–07. She reported that she recently had hired one new staff member, as the fiscal year 2008 budget includes funding for her to hire one supervisory IT auditor, and that the fiscal year 2009 budget includes a request for three new IG positions — two auditors and one investigator.

Ms. Ryan informed the Committee that her office had received three Congressional requests for information on the travel and other expenses of former museum director Rick West. In that regard, she noted that on January 3, 2008, she sent a letter to the Board of Regents informing them that her husband, a law professor, also works "of counsel" for the law firm engaged by Mr. West. She informed the Committee that she does not believe there is a conflict of interest. Nonetheless, she consulted with her office's attorney and the General Counsel, as well as with the Government Accountability Office ethics counselor, who also determined that there is no conflict of interest.

Update on Financial Disclosure Process

General Counsel John Huerta informed the Committee that he had fulfilled their guidance to reorder the Institution's financial disclosure form to reflect the layout of the form used by the Federal government. Employees will now indicate on the cover page whether they have reportable interests and will fill out the remainder of the form accordingly. After some discussion about whether the forms should be submitted directly to the General Counsel by employees or certified in some manner by either unit administrative officers or an employee's supervisor in the interest of increasing compliance, the Committee expressed a desire for a submission process no different than the Federal process. Mr. Huerta agreed to amend the process to conform it with the usual Federal approach.

Standards of Conduct

Mr. Huerta reminded the Committee that he had been asked at their October 2007 meeting to survey the practices of major state universities to establish to what extent their written standards of conduct expressly address the issue of personal relationships in the office. His survey revealed that while some institutions maintain an outright prohibition against personal relationships, the majority surveyed require disclosure of such relationships to supervisors. After much discussion, the Committee approved amending the Institution's Standards of Conduct, Smithsonian Directive 103 as proposed, requiring disclosure of personal relationships.

Smithsonian Collections Stewardship

National Collections Coordinator Bill Tompkins provided an overview of collections stewardship at the Smithsonian. He reminded the Committee that the Regents devoted their June 2006 meeting solely to the management of the Institution's collections. By way of background, he noted that museum accreditation signifies that a museum operates according to the highest and most current professional standards and best practices and fulfills its obligations to the public as put forth in its mission. Currently, 10 museums are accredited or undergoing accreditation by the American Association of Museums. Six museums were reaccredited during the past 5 years with three museums currently under review. He further reminded the Committee of the diversity, scope, and breadth of the Institution's collections. Currently, the Smithsonian is responsible for the care and management of 137.1 million objects and specimens. Ninety-two percent of the total (126.7 million items) are held by the National Museum of Natural History. Mr. Sant inquired as to why only 10 museums are accredited, and Bill Tompkins explained the reasons why some museums have not yet undergone the process. The Acting Secretary expressed his view that all museums at the Institution undergo the accreditation process and mentioned how useful the process was for the Museum of Natural History when he was its director.

Mr. Tompkins noted that collections stewardship is not a single process or procedure. The condition of the facilities housing collections, the quality of storage and preservation, and the ability to document collections in manual and electronic formats directly affect the Smithsonian's ability to make collections available to scholars and the general public. The Smithsonian carries out its collections stewardship responsibilities through the development and implementation of policies and standards that maintain a dynamic balance between the goals of preservation and accessibility.

Only a small percentage of the collections (approximately 2 percent) is on display at any given time. Many collections are acquired and solely used for research purposes. Exposure to risk can occur when collections are on exhibition or loan, in transit, in storage, or while being studied, treated, or handled. Risk management is a component of collections stewardship that requires the thoughtful review of potential hazards. The Smithsonian takes a preventive approach in the care, management, and use of collections — starting with the implementation of collections management policies and procedures based on industry standards and best practices. The Smithsonian also has taken a pragmatic and systematic approach to improve stewardship of Smithsonian collections. It has created the first-ever Smithsonian Collections Advisory Committee to assist senior management in establishing Institutional priorities for collections and implementing an action plan; started the Collections Care and Preservation Fund with an initial fiscal year 2006 Federal appropriation of $1 million to establish an Institution-wide program to systematically address critical needs in collections care; and developed collections-specific performance metrics for senior management and unit directors.

Smithsonian senior management acknowledges that an effective strategy for addressing collections challenges depends upon having a coordinated, pan-Institutional approach. New resources are urgently needed for collections care, preservation, and digitization efforts. In action on the fiscal year 2009 budget request, OMB agreed to double the funding request for the Collections Care and Preservation Fund with a $1 million increase, a fraction of the funds needed.

Mr. Tompkins noted that the risk of damage to or loss of collections is always a possibility. However, he gave his judgment that it is not a probability because of the actions the Smithsonian takes to eliminate, prevent, and minimize exposure to risk. He acknowledged that there are deficiencies in collections inventory and physical security, which the Institution is currently attempting to correct, and noted the imperative for additional funding.

Independent Report of Donald Chapin

Mr. Chapin, in a brief oral report, amplified and updated his December 24, 2007, memorandum to the Committee, which was drafted in response to his November 2007appointment to the Committee. He expressed his concerns about the Institution’s limited financial management resources and related longstanding weaknesses in internal controls; the lengthy period it is taking to install needed systems improvements, and the very serious problem of deferred maintenance.

He emphasized his belief that prompt actions are needed to address these concerns and challenged the Regents to consider how they might turn the situation around with bold action. He said that Congress should receive a more candid message about these issues and related financial requirements. He said that Acting Secretary Samper’s message in the Institution’s proposed “Management Discussion and Analysis” (provided to the Committee in advance of its meeting) was a good start toward improving communications, but that much more should be expressed to those whose support is necessary.

Mr. Chapin recommended that the Institution use such unrestricted Endowment funds as may be necessary to support much-needed financial management resources and pay for badly needed facilities restoration. He said that these steps would eliminate the deferred maintenance backlog over a reasonable period of time (approximately five years) by encouraging both contributions and increased Federal support.

Mr. Kogod thanked Mr. Chapin for his concerns, recommendations, and constructive criticism. He stated that he thought that things were moving forward at a good pace and welcomed additional suggestions in support of the effort. Mr. Sant and Ms. Stonesifer noted that they were troubled that Mr. Chapin was not aware of the progress that had been made to-date and agreed that the Regents should consider how to better relay such information to both the public and Congress.

Chief Financial Officer's Issues Update

Chief Financial Officer Alice Maroni addressed selected issues from her written update on the work of her office to the Committee. With regard to continuing concern about the adequacy of the Institution's accounting staff, she reminded the Committee of the Institution's phased plan to hire 10 new accountants and acknowledged that progress was slow in spite of the priority it had been given. She noted that the Institution was about to hire a Deputy Comptroller, a position critical to the performance of the audit and soon would replace the Institution's senior accountant. She reminded the Committee that the Washington area had become the tightest job market in the country for accountants. She outlined her plan for hiring newly minted accounting graduates and expanding the staff through mentoring and professional development. She added that the fiscal year 2009 budget request contains funding for two of the 10 accountants to be hired.

The CFO reviewed the status of the actions taken in response to KPMG's concerns during the fiscal year 2006 audit and noted that work continues on three issues that have not been fully resolved.

On the subject of governance reform, which remains the number one priority, the staff is heavily invested in completing the reform agenda. Workload adjustments have been made, and the number of policy compliance reviews to be completed this year has been reduced as a consequence. She informed the Committee that she anticipates providing a complete update on the work of the reform action teams at the Committee's April 2008 meeting.

With respect to travel administration, the new GovTrip travel management system has dramatically improved the Institution's ability to monitor travel authorizations and vouchers. Among other steps taken, the Smithsonian-wide travel approval process was reconfigured to correct situations where subordinates were approving the travel of superiors. The CFO highlighted two recent travel management reviews. The first so-called "gap" review showed that while the Institution's travel policy has been clarified, there continue to be areas where the Smithsonian could strengthen travel policy and travel management infrastructure; it was noted that efforts are already under way to address these deficiencies. In general, the "senior executive travel review" showed a pattern of policy compliance and responsible travel expenses, although one director's travel was considerably outside the range of the others. Notable anomalies in the data are still under review.

Lastly, with regard to internal controls, she updated the Committee on the work of the governance team that is evaluating the Institution's critical control processes. The work plan presented in October 2007 has been improved through consultation with KPMG and the IG and a third party will be hired to assist with the conduct of the review. As a consequence, the timeline is projected to slip beyond the original date anticipated by the Regents governance reform agenda.

The Committee adjourned its regular session and reconvened at 5:05 p.m. in separate executive sessions with KPMG, the Inspector General, and the Chief Financial Officer.