MINUTES OF THE MARCH 3, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On March 3, 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 included Roger Sant and Robert Kogod; Committee Chair Phillip Frost and members Patricia Stonesifer and Don Chapin participated by teleconference. Staff present included Acting Secretary Cristián Samper; Acting Under Secretary for Finance and Administration Alison McNally; Chief Financial Officer (CFO) Alice Maroni; Director of Investments Amy Chen; Office of the Inspector General Supervisory Auditor Bruce Gallus; Associate General Counsel Lauryn Guttenplan; General Counsel John Huerta; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; and Comptroller Andrew Zino. Also in attendance were Ellen Harrison, Rebecca Horton, and John Keenan, who represented the Institution's auditors, KPMG LLP. Minutes were taken by Susan Block, special assistant to the CFO.

The Chair opened the meeting and asked everyone in the Regents' Room to introduce themselves so that those on the phone would know who was present.

Update on Open Issues

Comptroller Andrew Zino reported that the audit was completed on time on February 15, 2008; that KPMG issued an unqualified audit opinion; and that KPMG reported no material weaknesses in internal control. He reported that the management letter indicated seven areas as "significant deficiencies" under the new Statement on Auditing Standards 112 guidelines and noted three items as "other observations." He told the Committee that management has responded to each of these comments and that KPMG has indicated that they are satisfied with the Institution's responses. He reported that the overall audit process was considerably improved over the prior year in terms of communication between his office and KPMG.

Mr. Zino informed the Committee that several significant entries were made to the financial statements since the interim report to the Committee in January 2008. First, he reported that an adjustment was made to reduce contributions revenue by $6.8 million (from $174.9 million previously reported to $168.1 million) as a result of a deferral in the payment schedule for a pledge due from a major donor to the National Museum of American History. Because of the change in the timing of expected payments under the pledge agreement and in accordance with not-for-profit accounting guidelines, the Institution was required to record a greater discount to present value on the pledge-receivable balance of this donor.

Mr. Zino noted that this reduction in revenue was almost completely offset by the recording of two reductions of expenses: $4.6 million in rent expense was erroneously recorded by Office of the Comptroller (OC) staff when preparing information in connection with the current year's audit and $2.1 million in over accrued prior years' payroll expenses was reversed. The net impact of these late revenue and expense adjustments reduced the previously reported net asset increase of the Institution for fiscal year 2007 by only $0.1 million. Appropriate entries to reflect the reduction in pledge-receivables and expense accrual balances also were made to the financial statements for these items.

Mr. Zino then reported that the temporarily restricted net asset balances reported in the earlier draft of the financial statements had been modified by –$24.1 million, based upon KPMG's review of the roll forward of activity in the grants and contracts audit information supplied by the Office of Sponsored Projects (OSP). The review of other OSP audit schedules also resulted in –$13.1 million in additional adjustments to the balances of net assets released from restrictions during the fiscal year.

At the Committee's January 2008 meeting, the Comptroller was asked to explain the large reduction in research expenses indicated in the draft financial statements presented at that time. Mr. Zino reported that, after further review and finalization of expense allocations, it was discovered that an adjustment to the Federal portion of the expense analysis had not been properly reflected in the draft financial statements. The corrected allocated expense balance for research expenses was $239.5 million in fiscal year 2007, versus $243.2 million in fiscal year 2006. This change represents only a 1.5 percent reduction ($3.7 million) in research expenses during fiscal year 2007 and is due to the continued slowdown in spending activity at the Smithsonian Astrophysical Observatory in connection with work performed for the National Aeronautics and Space Administration. Other expense balances for program activities in collections management and education, public programs, and exhibitions were impacted by immaterial amounts as a result of this adjustment.

Mr. Zino also noted that, in response to the changes discussed above, some minor adjustments were made to footnote disclosures in the previous draft financial statements to reflect the changes in the related balance sheet accounts. In addition, minor refinements were made to the lease commitment disclosures in footnote 14(a). Other than these changes, he stated that the footnote disclosures were unchanged from those reviewed at the January 2008 meeting of the Committee.

KPMG's Fiscal Year 2007 Financial Statement Audit Opinion

John Keenan, senior partner with KPMG LLP, informed the Committee that, in accordance with the original audit plan and timetable, KPMG had completed its audit of the financial statements of the Smithsonian for fiscal year 2007, which ended September 30, 2007. He reminded the Committee that KPMG's responsibility is to conduct the audit of financial statements in accordance with professional standards and that, in carrying out that responsibility, KPMG had planned and performed the audit to obtain reasonable assurance that the financial statements were free of material misstatement from either error or fraud. He reported that, in planning and performing the audit, internal control over financial reporting was considered as a basis for designing auditing procedures that express an opinion on the Smithsonian's financial statements, not the effectiveness of its internal controls. Accordingly, KMPG did not express an opinion on the effectiveness of the Smithsonian's internal control.

Mr. Keenan stated that the significant accounting policies followed by the Smithsonian are described in note 2 to the financial statements. He said there had been no changes in these policies or their application in fiscal year 2007 except that, in order to comply with the requirements of U.S. generally accepted accounting principles, the Smithsonian adopted

Financial Accounting Standards Board Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* in fiscal year 2007. He noted that this new standard only had an inconsequential effect on the Smithsonian's financial statements and is discussed in Note 11 in the financial statements.

He informed the Committee that significant management judgments and accounting estimates were required in six areas in fiscal year 2007, including: (1) valuation of investments not readily marketable; (2) valuation of contributions receivable (both the allowance for uncollectible accounts and the discount to present value); (3) classification of contributions and net assets; (4) useful lives of property and equipment; (5) functional presentation of expenses; and (6) valuation of actuarial liability for workers' compensation benefits. He stated that KPMG had reviewed the support for those estimates and judgments and determined that, taken as a whole, they were reasonable in relation to the financial statements for fiscal year 2007.

Mr. Keenan reported that KPMG proposed nine audit adjustments, which were recorded by management and increased net assets by an aggregate amount of $2,315,000. He informed the Committee that in connection with the audit of the financial statements, certain other financial statement misstatements (which were detailed in KPMG's Statement on Auditing Standards 61 letter report to the Committee) had not been corrected in the books and records for the year ended September 30, 2007. He noted that KPMG has received written representations from management that management believes that the effects of the uncorrected financial statement misstatements and disclosures are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Mr. Keenan informed the Committee that there have been no disagreements with management on financial accounting and reporting matters that, if not satisfactorily resolved, would have caused a modification of KPMG's report on the Smithsonian's fiscal year 2007 financial statements. He also reported that, to the best of KPMG's knowledge, management had not consulted with or obtained opinions — written or oral — on the application of accounting principles from other independent accountants during fiscal year 2007; that there were no major issues discussed with the Committee or management prior to KPMG's retention as auditors for fiscal year 2007; and that KPMG had experienced no difficulties in dealing with management in performing the audit.

Mr. Keenan then introduced Ellen Harrison, who discussed the management letter. Ms. Harrison reported that KPMG had not identified any material weaknesses in internal control in performing the fiscal year 2007 audit and that the controls and processes supporting management's valuation of non-marketable investments, which that had been a problem in fiscal year 2006, had been significantly improved this year. That improvement was a consequence of hiring more staff in the Office of Investments and better record keeping. She stated that shortages in staff resources in the Office of the Comptroller continue to be an issue. She also recommended that OC staff increase the level of monitoring of information provided by other units and initiate appropriate training of staff in other units.

Chief Financial Officer Alice Maroni agreed with KPMG and reminded the Committee that she has a plan to hire 10 accountants, five of whom would work in OC and five of whom would work for the Comptroller but be assigned to other Smithsonian offices. She reported that the Deputy Comptroller has been hired and will report on March 17, 2008, and that the position under the senior accountant in OC also had been filled. She reiterated that she is working with the Office of Human Resources (OHR) to make accounting jobs in OC more attractive and informed the Committee that the process of advertising positions on local college websites also had begun.

Ms. Harrison then introduced Rebecca Horton, who discussed the significant deficiencies cited in the management letter. Ms. Horton reviewed with the Committee, one by one, the seven significant deficiencies that were reported in the management letter and the Comptroller informed the Committee of his plan of action to remediate each.

Ms. Stonesifer opined that she was distressed that for the second time the lack of resources in the OC appears in the management letter. She told the Acting Secretary and the Acting Under Secretary for Finance and Administration that she sees this as a senior management problem and asked what their plan is to address it. Ms. McNally informed the Committee that she has a monthly metrics meeting with the CFO where her recruitment efforts are discussed. She and the CFO have had discussions with the Office of Human Resources (OHR) concerning additional recruiting incentives that could be used to attract qualified individuals. Ms. Stonesifer stated that the Committee needs to better understand the plan of action that the OHR and the CFO have in mind. She also told the Acting Secretary that she thinks that he must find a way to fund the two OC positions that are requested in the fiscal year 2009 budget request, whether or not the Congress gives the Institution the money. Mr. Sant suggested that an out-of-cycle meeting be held to discuss this issue and agreed that it would be a problem if this significant deficiency appeared again in next year’s management letter.

Mr. Chapin cautioned the CFO and the Comptroller that they need to ensure that their evaluation of how many staff are needed is based upon a comprehensive review, not an informal estimate.

The CFO reported to the Committee that she currently is preparing a resource requirements paper that goes well beyond the Institution’s requirements for accountants. It is her intention to share it with the Committee once it is complete.

Remarks by the Inspector General

Inspector General Sprightley Ryan introduced Bruce Gallus of the Office of the Inspector General (OIG). Mr. Gallus, the financial audit manager for OIG, is that office’s technical representative to the contracting officer for the audit contract with KPMG. Ms. Ryan reminded the Committee that part of her office’s responsibility is to prepare a quality assurance letter and that she intended to furnish such documentation to the Committee by the end of March 2008. She indicated that the letter will note that KPMG met all appropriate audit standards and that there was notable improvement in the process over the prior year, particularly in the audit of information provided by both Smithsonian Business Ventures and the Office of Investments. The OIG letter also will note that there continues to be room for improvement, given the audit findings that remain unresolved. Finally, the IG remarked that the CFO’s office had outstanding recommendations from the OIG, KPMG, and the Regents’ Governance Committee. The OIG letter also will recommend that the CFO develop a comprehensive plan that identifies and prioritizes all of the recommendations and assigns responsibilities and deadlines for each task.

Dr. Frost asked the Inspector General to conduct a review of the Office of Development, given the percentage of the Trust budget for which they are responsible. She stated that her office would do that.

Executive Session

The Committee adjourned at 4:00 p.m., after which separate executive sessions were conducted with KPMG and the Inspector General.

MINUTES OF THE APRIL 16, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On April 16, 2008, the Regents' Audit and Review Committee ("the Committee") met at 2:00 p.m. in the Regents' Room in the Smithsonian Castle. Committee member Robert Kogod attended in person. Chair Phillip Frost, Roger Sant, and Patricia Stonesifer participated by teleconference. 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; Associate Director of the Office of Human Resources Greg Bettwy; Director of the Office of Human Resources Jim Douglas; Director of the Office of Contracting and Personal Property Management Robert Fraga; 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; Deputy Comptroller Stella Whitsell; and Comptroller Andrew Zino. Minutes were taken by Susan Block, special assistant to the CFO.

Committee Chair Phillip Frost opened the meeting and asked everyone in the Regents' Room to introduce themselves so that those on the phone would know who was present. A motion was made and seconded and the January 2008 minutes were approved. Mr. Frost then turned the meeting over to CFO Alice Maroni. She reminded the Committee that they had asked for a status of the open audit comments from KPMG's management letter for the past two fiscal years. She then turned the meeting over to Comptroller Andy Zino.

Audit Corrective Action Plan

Comptroller Andrew Zino reminded the Committee of the issues identified for action by KPMG. He informed the Committee that an action plan had been prepared that notes each audit condition, the office responsible for the corrective action, the anticipated milestones associated with resolving each issue, a target date, and current progress status. He highlighted a number of areas for the Committee's review. First, with respect to hiring accountants, he noted that the completion date is forecast for the second quarter of fiscal year 2009, since funding for the last two Federal accountant positions is currently pending before Congress as part of the fiscal year 2009 budget request. He deferred discussion of the accountant staffing issue until later in the meeting. Second, with respect to developing a new process for tracking outstanding pledge commitments, Mr. Zino noted that the completion date is forecast for September 30, 2009, beyond the end of the current fiscal year because of the anticipated workload for the Office of External Affairs associated with the completion of this task. Third, with respect to the need for documentation of accounting policies and procedures, he noted a planned completion date of September 30, 2010, also beyond the end of the current fiscal year, reflecting the fact that he has engaged a contractor for this purpose and there are limited staff and funds available to accelerate the timetable for completion of this task.

Mr. Sant and Ms. Stonesifer stated that they had concerns about the Office of the Comptroller's inability to perform a "hard quarterly close" of the Institution's books. Ms. Maroni reminded the Committee that, through the efforts of the Comptroller, the Institution's books are now being closed by the second day of the month, compared to the previous practice of closing on the 10th day of the month. The current practice, however, is not a hard close, as many of the Smithsonian offices that provide financial information to the Comptroller continue to have difficulty providing data timely and accurately. In response to a question, Ms. Maroni said that this was not due to the ERP implementation schedule, but was due rather to staffing shortages and the workload in other Smithsonian offices. She reminded the Committee that, due to Congressional funding cuts, the schedule for the completion of the ERP financial system implementation slipped shortly after the system's initial deployment in fiscal year 2003. Although originally scheduled for completion in fiscal year 2005, the implementation of ERP will now conclude in fiscal year 2010. She reported that a critical *PeopleSoft* software upgrade is occurring this year, and that the last two system modules to be implemented in fiscal year 2009 and 2010 (pertaining to grants and contracts, as well as project accounting) will not affect core accounting timeliness or accuracy.

With respect to the plan to produce documentation of accounting policies and procedures, Ms. Stonesifer asked why it would take so long to complete, given the likely existence of some policies and procedures. Mr. Zino explained that the planned documentation is a substantial project that has been impacted by ongoing staffing issues and the fact that, although basic policies and procedures exist, they do not satisfy KPMG's recommendation. He added that a contractor has been hired to prepare the required documentation and that an outline for the procedures manual was completed in January 2008.

Mr. Zino then discussed the Institution's staff accountant recruitment issues. He reminded the Committee of the market conditions and the great difficulty Federal agencies are having in hiring and retaining accountants. He noted that the Federal Chief Financial Officers Council reports that 40 percent of Washington area accountant positions remain vacant year-to-year and that, according to a recent article in the *Washington Post*, there are 325,000 posted accountant positions nationwide. He noted that the private sector is offering recent accounting graduates starting salaries of $60,000–100,000, whereas the Federal sector offers $40,000–48,000. The Institution is at a further disadvantage because its audit accountant positions are not entry-level positions. He informed the Committee that he is not only trying to fill the new audit accountant positions, but also is addressing routine staff vacancies as well. At the end of March 2007, the Office of the Comptroller had 60 staff (a combination of 51 regular staff and 9 contractors) and five vacancies. The audit requirement added 10 more vacancies, three of which have been filled — the Office of Investments hired an accountant; the Deputy Comptroller has been hired; and one more individual recently was hired pending a background investigation. Mr. Zino then discussed the Institution's hiring process, which takes approximately 90 days to complete. Further, he outlined the actions that are being taken to improve the Institution's hiring and make these accountant positions more appealing.

The Committee was advised of the necessary application of Office of Personnel Management rules in the Federal hiring process. The Federal hiring process is structured to be fair with regard to minimum applicant qualifications that do not always meet those dictated by the job opening. For example, to qualify for a Federal accountant job, an individual does not need to have an accounting degree. As long as an applicant has 24 hours of accounting, he or she is considered minimally qualified for a Federal accountant position.

The Committee had a lengthy discussion on how to improve the hiring process, what additional incentives could be used, whether the critical accountant positions should be Trust-funded rather than Federally funded, and how the Committee could be of assistance. Specifically, the Committee discussed additional means of advertising, such as running continuous job announcements; creating better incentives such as career ladders; recruiting at colleges and job fairs; offering higher salaries; outsourcing; exploring the retiree pool; improving the marketing of “mission-ties”; and increasing the efficiency of current staff. Ms. Maroni requested time to assess the success of the hiring incentives that have recently been put in place. The Committee agreed, but asked to be kept informed and suggested that she not lower the hiring standards just to fill a vacant accountant position.

Ms. Maroni was asked if these were the only vacancies that she had in her entire organization. She informed the Committee that she has prepared a resource requirements analysis paper in response to Governance Recommendation #11, which details the needs of her entire organization. It was decided that this issue would be discussed in executive session with the Committee.

Governance Recommendation #23, Internal Controls

Due to time constraints, Ms. Maroni took questions regarding Governance Recommendation #23, which addresses internal controls, in lieu of presenting the material provided in the read-ahead materials provided to the Committee. In response to a question about delays in the project’s schedule, she informed the Committee that she had taken on the responsibility of the project herself in the absence of staff to whom she can delegate responsibility. She will be assisted by a consultant that the Institution recently engaged for this purpose. Due to the workload associated with the preparation of the financial statements and the conduct of the financial statement audit, senior financial staff in the OC were not able to participate in this project until now. At the Committee’s request, she agreed to provide the results of the control review as the results become available.

Executive Sessions

The Committee adjourned at 3:40 p.m., after which two executive sessions were conducted, one of which included CFO Maroni.