Minutes of the January 24, 2013, Audit and Review Committee Meeting

The Audit and Review Committee ("Committee") of the Board of Regents met on January 24, 2013. Participating were Committee Chair John McCarter and Committee members Shirley Ann Jackson, Representative Sam Johnson, and Robert Kogod. Senator Jack Reed was unable to participate. Board of Regents Chair France A. Córdova participated at the invitation of the Committee. Special Advisor to the Committee Herb Schulken also participated.

Staff attending for all or part of the meeting included Secretary 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; Assistant to Senator Reed Moira Lenehan-Razzuri; General Counsel Judith Leonard; Director of Government Relations Nell Payne; Deputy Comptroller Stephen Wills; 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").

CALL TO ORDER

Mr. McCarter called the meeting to order at approximately 2:05 p.m.

APPROVAL OF THE OCTOBER 2, 2012, MEETING MINUTES

The Committee approved the draft minutes of the October 2, 2012, meeting without modification.

NOMINATION OF EXTERNAL INDEPENDENT AUDITORS

Mr. McCarter excused members of the KPMG audit team from the meeting to allow discussion on the Committee's nomination to the Board of Regents of the Smithsonian's external independent auditors for a one-year period beginning May 2013. After a brief discussion on the selection process, the Committee approved the following motion:

> **VOTED** that the Audit and Review Committee nominates KPMG, LLP to the Board of Regents to serve as the Smithsonian Institution's external auditors for a one-year period beginning May 2013 with four one-year options.

Mr. Schulken observed that the procurement process mirrored that of many private sector and non-profit organizations and was very thorough. Ms. Leonard reminded the Committee that the nomination must remain confidential until action by the full Board. [**NOTE**: On January 28, 2013, the full Board accepted the Committee's recommendation and appointed KPMG as the Smithsonian's external auditors for a one-year period beginning May 2013 with four one-year options.]

STATUS OF KPMG FISCAL YEAR 2012 FINANCIAL STATEMENT AUDIT

KPMG Senior Partner Ellen Harrison noted that KPMG regularly presents the results of the "closing package" special-purpose financial statements audit (for Federal funding) at the Committee's January meeting. She said that the audit was completed in accordance with Department of Treasury and Office of Management and Budget ("OMB") requirements and on time. KPMG issued an unqualified opinion to accompany the audit.

The audit of the Smithsonian-wide financial statements (Federal and Trust) is continuing. Ms. Harrison said that KPMG is on schedule to complete the audit by January 31, 2013.

With regard the Federal closing package, Mr. Schulken asked why the Smithsonian does not follow generally accepted accounting principles, also known as GAAP, in two instances identified by KPMG: (1) "conditional asset retirement obligations" and (2) "imputed costs." Mr. Zino explained that the current contracting procedures do not easily accommodate GAAP-consistent conditional asset assessment of environmental remediation liabilities for Smithsonian facilities. A number of new systems and changes in practices would be necessary to follow GAAP in this area. To follow GAAP policy on "imputed costs," Mr. Zino said, would require "gross-ups inconsistent with the way financial information was coming across the Institution." He stressed that KPMG concurred with management's determination that both differences were "immaterial." Mr. Horvath said that management planned to reconsider its position on these two areas annually as part of the audit process. Ms. Harrison noted that similarly situated organizations have approached these two policy issues in a manner similar to that of the Smithsonian.

Ms. Harrison again noted that no material weaknesses or significant deficiencies were noted in the Federal closing package. She said that KMPG did identify two control deficiencies that will be including in KPMG's Smithsonian-wide management letter: (1) errors identified related to the cutoff of expenses, and (2) the review and approval of manual journal entries at decentralized units.

Ms. Harrison and Mr. Horvath agreed with Mr. McCarter's observation that unit financial staff need to better communicate and coordinate with the central financial offices. Mr. Horvath said that management would continue to focus on ensuring an appropriate control environment for financial reporting.

With regard to the continuing Trust financial audit, Ms. Harrison said that no material weakness or significant deficiencies had been identified to date. She said that KMPG did have a "number of observations" that will be discussed with management. "All in all," she said, the review process was "smooth," and, in response to a member's question, previous problems regarding the collection of endowment-related information had been resolved.

CHIEF FINANCIAL OFFICER'S ISSUES UPDATE

Mr. Horvath reminded the Committee that in August 2012, Smithsonian management learned about significant parking fee thefts by a contractor's employees at the Steven F. Udvar-Hazy Center. The thefts, along with more minor instances at the National Zoological Park, prompted management to conduct a review of cash-handling activities throughout the Smithsonian. Outside consultants Booz Allen Hamilton (BAH) were engaged to assist with the review. Mr. Horvath noted that BAH found that the process and procedures used by units handling significant cash generally reflected best practices. [**NOTE**: The BAH report was included in the Committee's meeting materials.] Moreover, BAH concluded that greater coordination of oversight by central units will add to the control environment for outsourced cash-intensive activities, including standard policies, guidelines for review of third-party activity, and consistent exercising of audit rights standard contract language. BAH also recommended that the Smithsonian seek opportunities to consolidate oversight of cash intensive operations. Mr. Horvath underscored BAH's finding that the Smithsonian's central auditing function needs to be better aligned with individual units' management of their third-party cash operations.

Mr. Horvath detailed management's short-term (September 30, 2013), mid-term (March 31, 2014), and continuing action plans to "develop a holistic and standard process approach to cash operations" in response to the BAH recommendations. He said that planned steps included, among other things, exploring opportunities for more oversight by Smithsonian Enterprises in cash-intensive activities and the implementation of a regular auditing calendar.

Mr. McCarter congratulated Mr. Horvath and his team on moving forward so quickly on these critical cash operations issues.

INSPECTOR GENERAL UPDATE

Top Management Challenges and Audit Recommendations. Mr. Dahl reviewed the five top management challenges for the Smithsonian identified by the Office of the Inspector General (OIG): (1) construction management; (2) collections stewardship; (3) financial management; (4) cash handling operations; and (5) information system security. He noted that the OIG's report on the challenges was "well-received by management," and that the office anticipates issuing a similar report annually. Mr. Dahl also noted that "substantial progress" has been made on closing outstanding audit recommendations.

Audit Program. Mr. Dahl noted that the OIG is in the final stages of its audit of senior executive travel. He briefly described the progress on other audits identified in the meeting materials.

Udvar-Hazy Theft Update. Mr. Dahl updated the Committee on the status of the parking fee thefts at the Udvar-Hazy Center. He said that one defendant in the criminal prosecution pled guilty and was sentenced to 20 months in prison and ordered to pay $480,000 in restitution. The second defendant will be sentenced on February 8, 2013. Mr. Dahl noted that he and Ms. Leonard have been working with the Department of Justice to initiate the civil recovery process for the stolen parking fees.

EXECUTIVE SESSION

The Committee then conducted a series of executive sessions with KMPG, the Chief Financial Officer, and the Inspector General, after which the members met alone.

The meeting was adjourned at approximately 4:20 p.m.

Respectfully submitted,

John McCarter, Chair