Notes of the April 18, 2013, Audit and Review Committee Meeting

On April 18, 2013, the Audit and Review Committee ("the Committee") met in the Regents' Room of the Smithsonian Castle. Participating for all or part of the meeting were Committee Chair John McCarter and Committee members Representative Sam Johnson and Robert Kogod. Special Advisor to the Committee Herb Schulken also participated. Committee members Barbara Barrett, Shirley Ann Jackson, and Senator Jack Reed were unable to participate.

Participating staff included Treasurer Sudeep Anand, Chief of Staff to the Secretary Patricia Bartlett; Inspector General (IG) 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; General Counsel Judith Leonard; Director of Government Relations Nell Payne; and Comptroller Andrew Zino. Also in attendance were Joanna Friedman and Ellen Harrison, who represented the Smithsonian's external auditors, KPMG LLP ("KPMG").

Mr. McCarter called the meeting to order at 11:05 a.m.

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

STATUS OF THE FISCAL YEAR 2012 FINANCIAL STATEMENT AUDIT RESULTS AND MANAGEMENT LETTER

Mr. Zino directed the Committee to materials on the fiscal year (FY) 2012 financial statement audit results and management letter, including the statement of management's position. He reviewed the documents and directed the Committee members to the summary of the statement of financial position. Mr. Zino noted that, among other highlights, FY 2012 ended with cash balances with the United States Treasury up by $24.9 million, principally due to the timing of the purchase and redemption of investment securities, the expenditure of Federal funds, and a policy to maintain higher cash balances.

Total liabilities increased by $15.5 million, or approximately 2 percent. He added that total net assets increased by $263.7 million, or 9.5 percent, due primarily, Mr. Zino noted, to improved market conditions.

With regard to the audit's statement of financial activity, Mr. Zino directed the Committee to the statement on operating revenues, which were up by $96.8 million or 7.6 percent from FY 2011. He primarily credited the "fantastic job" by the Office of Advancement in increasing contributions to the Smithsonian by approximately 51 percent.

Mr. Zino explained that in FY 2012, the Smithsonian adopted an alternative methodology for allocating certain facilities-related costs (such as safety, security, and depreciation and amortization) that are recorded and managed centrally. These costs are now allocated based on the square footage of space occupied by the respective activities instead of a mathematical allocation based on the total applicable costs of these activities.

The principal difference in the non-operating activities, Mr. Zino said, was the swing in non-operating investment returns from a net loss of $49.5 million on FY 2011 to a net gain of $65.6 million in FY 2012.

In response to a question by Mr. Schulken regarding the impetus for the allocation methodology change, Mr. Horvath explained that the costs being allocated were facilities-related costs. Consequently, he said, allocating the costs by facilities square footage was more appropriate than on an activity's total budget.

KPMG REPORT ON FISCAL YEAR 2012 FINANCIAL STATEMENT AUDIT AND MANAGEMENT LETTER

KPMG Senior Partner Ellen Harrison began KPMG's presentation on the fiscal year 2012 audit results and management letter. Before she began her report, Mr. McCarter noted that he had contacted Ms. Harrison about a recent issue involving a KMPG partner in Los Angeles, California. He said that he does not believe the partner's actions impact KPMG's work for the Smithsonian.

Ms. Harrison noted that KMPG issued the audit report on January 31, 2013, as scheduled. Ms. Harrison characterized it as "an unqualified, clean audit report." She said that KMPG focused most of its efforts on non-routine transactions and key accounting estimates related to the investment portfolio.

She then presented KPMG's "required communications" with regard to the firm's responsibility under professional standards. Among other things, she noted that there were no significant accounting policy changes in FY 2012 and no significant unusual transactions. The accounting judgments and accounting estimates appeared reasonable, she said. In response to a question by Mr. Kogod, Mr. Zino explained the allowances made for accounts receivable that are uncollectable (approximately $1.8 million in pledged donations).

Ms. Harrison described an audit adjustment that required a reclassification from "temporarily restricted net assets into unrestricted net assets of $14.9 million." The reclassification, she said, "did not impact the bottom line." She then described a series of uncorrected audit differences by management that KMPG agreed were immaterial. The details of these differences, she added, were listed in the audit cover letter. Ms. Harrison said that no material disagreements with management were raised and that "management cooperated fully with [KPMG]."

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 deficiencies not rising to the material level, including the treatment of certain temporarily restricted net assets; certain discrepancies in the accounting and record-keeping between supporting schedules for fixed assets, accruals, and deferred rent liability, when compared to the general ledger; inconsistent polices applied between or among different Smithsonian units; instances where the ERP Oracle database and Solaris servers have not been patched in over a year; and untimely debt covenant information submissions. She said KMPG recommends that the Office of Comptroller continue to leverage its accounting expertise through training and by advising the units producing accounting information.

Mr. McCarter asked whether any of the management letter comments, if not addressed, could evolve into a significant deficiency in FY 2013. Ms. Harrison suggested that the cut-off period for cash contributions by the Office of Advancement be modified, adding that the quality of accounting information from units has the potential to be an audit deficiency in the future. Mr. Horvath described the improvements made over the past few years in gift accounting and agreed with Ms. Harrison that increasing the reliability of information from the units is likely one of the greater immediate challenges.

REPORT OF THE INSPECTOR GENERAL

Before beginning his report, Mr. Dahl said that he was also concerned about the "disparity" in accounting expertise between the central administration and the units. The Office of the Inspector General (OIG) is encouraged, however, by recent efforts to centralize more of the financial processes.

Mr. Dahl presented a brief status report on the criminal and civil recovery proceedings arising from the theft of parking fees by a contractor's employees at the National Air and Space Museum's Steven F. Udvar-Hazy Center.

Mr. Dahl directed the Committee's attention to the OIG's November 2012 Top Management Challenges chart in the meeting materials and noted the progress that has been made to address each challenge. He also described efforts to better orientate new Smithsonian executives about the OIG and the office's work.

Mr. McCarter commended Mr. Dahl on the informational brochures being developed by his staff on various issues, including understanding the OIG investigative process.

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) and focuses primarily on addressing catastrophic loss on Trust assets. For Federal losses, he explained, the Smithsonian relies on additional Federal appropriations to cover any damages.

He noted that the Department of Justice (DOJ) represents the Smithsonian against claims, and said that judgments are paid out of the Federal judgment fund administered by DOJ.

Mr. Anand then reviewed the three classes of policies the Smithsonian purchases—real and personal property, directors and employee liability, and special purposes—and the insurance carriers with which the Smithsonian currently does business.

Mr. Anand then highlighted the results of a benchmarking analysis of Smithsonian insurance coverage as compared with certain other similar organizations (e.g., museums and public universities) and the Smithsonian's efforts to ensure that the premiums paid are as low as possible. With regard to making comparisons with other organizations, Mr. McCarter urged Mr. Anand to better account for the benefit of the Federal contribution in insuring Smithsonian assets and activities. Without such an acknowledgment, he said, the comparison is not "apples to apples."

UNDER SECRETARY FOR FINANCE AND ADMINISTRATION AND CHIEF FINANCIAL OFFICER'S REPORT

Mr. Horvath updated members on three issues previously considered by the Committee. First, he noted that, on April 14, 2013, Smithsonian Enterprises assumed control of the Udvar-Hazy parking facility operations from the outside contractor. Internal controls have been developed in consultation with an outside parking consultant. Mr. McCarter thanked Mr. Kogod for providing guidance on the parking management issues and alternatives at Udvar-Hazy.

Mr. Horvath next noted that management is on course to implement the short-term cash operations improvements recommended by Booz Allen and Hamilton. Most notable, he said, the Smithsonian will conduct an internal audit of all major cash handling operations by the end of September 2013.

Mr. Horvath provided a status report on the management response to the Inspector General's report of senior executive travel. He said that all actions in response to the OIG recommendations would be completed by the target dates.

AUDIT COMMITTEE CHARTER REVIEW

Ms. Leonard noted that a member of the Audit and Review Committee requested clarification about the provision in that Committee's chart that states that:

> *[i]ndividuals currently associated with the Smithsonian Institution's fund raising, finances, or programs such that a reasonable person might question that individual's independence and ability to evaluate without bias the Institution's financial reports may not serve on the Audit and Review Committee.*

The Regent was concerned that her position as co-chair of the Smithsonian national campaign was the type of association with fundraising that was in conflict with this provision. Ms.

Leonard noted that the “intent” of the Charter provision was unclear, but said that she did not believe that service as co-chair of the campaign would preclude participation on the Audit and Review Committee. She noted that the Governance and Nominating Committee also considered the question at its March 28, 2013, meeting and concluded that leadership of the national campaign would not lead a reasonable person to question that Regent’s independence or ability to evaluate Smithsonian financial reports.

Ms. Leonard noted that the wording of provision was imprecise and confusing, and said that a revised draft Charter was distributed to the Committee for consideration. The revision contained a more general conflict of interest provision to replace the provision at issue, as well as other minor updates. She said that revised provision could be adopted into all Regent committee charters.

Mr. McCarter said that he had discussed the revisions with Governance and Nominating Committee Chair Roger Sant and that both concurred with Ms. Leonard’s suggestions. The Governance and Nominating Committee will consider the final updated Committee charter at a future meeting.

EXECUTIVE SESSION

The Committee then conducted executive sessions with KPMG, the Inspector General, and the General Counsel.

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

Respectfully submitted,

John McCarter, Chair