We performed this audit to address concerns raised by various parties regarding issues in the financial management of the organization. The objectives of this audit were to assess whether the SE Office of the Chief Financial Officer (CFO): (1) collaborated with division management to accurately and timely report financial data; (2) provided transparent accounting services to museum partners; and (3) established clear roles, responsibilities, and lines of accountability. We also assessed employee morale as it relates to financial management operations.

We made nine recommendations that instruct the President of SE to direct Retail and Corporate to collaborate during and develop written procedures for the budgeting and execution of capital projects; modify the attestation letters; provide more transparent information to museum partners; and evaluate, modify, and document the allocation methodology.

Management did not agree with our findings, but generally agreed with our recommendations.

Smithsonian Enterprises (SE) comprises the majority of the revenue-generating operations of the Smithsonian Institution and operates three divisions of business activities: Retail, Media, and Consumer Products. The Corporate division provides support for these three divisions.

The President of SE is responsible for promoting efficiency and increasing income contributed to the Smithsonian. As such, the efficiency and effectiveness of SE’s financial management operations is essential to its overall success.

We determined that the Corporate and Retail divisions of SE do not effectively collaborate with each other, have unclear roles and responsibilities, and are not fully transparent to museums with regard to financial information. In addition, SE’s allocation methodology may not fairly distribute costs.

Regarding collaboration, and roles and responsibilities, we found that the Corporate and Retail relationship is counterproductive, which adversely affects SE’s ability to provide support to its stakeholders. Continued conflict between the groups and management’s inability to resolve those disputes has affected financial statement attestations; increased disagreements over overhead (Corporate- and Divisional-shared service) allocations and execution of capital projects; and puts SE’s relationships with some museums at risk.

We also found that the financial information that SE presents to the museums could be more transparent. Some information SE presents at its annual directors’ meeting is outdated. Furthermore, SE does not involve all museums in regular discussions regarding direct and indirect costs, as required by Smithsonian policy. SE could also improve the presentation of indirect costs on its museum profit and loss (P&L) statements, which would make their financial information clearer.

SE allocates its overhead to museum partners to align the expenses associated with running retail operations. Because of the way SE develops some of its allocation percentages, the museums may not realize the full amount of any cost avoidance associated with canceled or postponed projects. Moreover, we question the basis SE uses to allocate some of its costs, and believe that allocating using this basis negatively affects the smaller museums, which already incur high salaries and benefits expenses in relation to their revenue.

For additional information or a copy of the full report, contact the Office of the Inspector General at (202) 633-7050 or visit http://www.si.edu/oig.
Date September 07, 2011

To Tom Ott, President, Smithsonian Enterprises
Kenneth F. Johnson, Acting Director, Office of Planning, Management, and Budget

cc Carol LeBlanc, Vice President, Smithsonian Enterprises
Greg Bokman, Chief Financial Officer, Smithsonian Enterprises

From A. Sprightley Ryan, Inspector General

Subject Audit of Smithsonian Enterprises Financial Management Operations, Number A-10-12

This report presents the results of our audit of the financial management operations at Smithsonian Enterprises (SE). The Office of the Inspector General (OIG) initiated this audit to address issues in the financial management of the organization.

Specifically, we were informed of concerns raised by various parties regarding allocation budget errors; museum revenue-share errors; and uncertainty over roles, responsibilities, and accountability.

The objectives of this audit were to assess whether the SE Office of the Chief Financial Officer (CFO): (1) collaborated with division management to accurately and timely report financial data; (2) provided transparent accounting services to museum partners; and (3) established clear roles, responsibilities, and lines of accountability. We also assessed employee morale as it relates to financial management operations. While the objectives specifically refer to the Office of the CFO, we focused our efforts equally between the Corporate, which includes the Office of the CFO, and Retail divisions. We include a detailed description of our scope and methodology in Appendix A.
RESULTS IN BRIEF

We determined that the Corporate and Retail divisions of SE do not effectively collaborate with each other during the budgeting process or while executing capital projects, have unclear roles and responsibilities, and could improve their transparency to museums with regard to financial information. In addition, SE’s allocation methodology may not fairly distribute costs.

Regarding collaboration, and roles and responsibilities, we found that the Corporate and Retail relationship is counterproductive, which adversely affects SE’s ability to provide support to its stakeholders. Continued conflict between the groups and management’s inability to resolve those disputes has affected financial statement attestations; increased disagreements over Corporate- and Divisional-shared service (overhead) allocations and execution of capital projects; and put SE’s relationships with some museums at risk. We believe the lack of collaboration also negatively affects SE employee morale.

We also found that the financial information that SE presents to the museums could be more transparent. Some information SE presents at its annual directors’ meeting is outdated. Furthermore, SE does not involve all museums in regular discussions regarding direct and indirect costs, as required by Smithsonian policy. SE could also improve the presentation of indirect costs on its museum profit and loss (P&L) statements, which would make their financial information clearer.

SE allocates its overhead to museum partners to align the expenses associated with running retail operations. Because of the way SE develops some of its allocation percentages, the museums may not realize the full amount of any cost avoidance associated with canceled or postponed projects. Moreover, we question the basis SE uses to allocate some of its costs. Best practices suggest that SE should assign costs on a cause-and-effect basis. We do not believe that full-time equivalents (FTE) have a causal relationship with the majority of the costs that SE allocates. When SE allocates costs using this basis, it negatively affects the smaller museums, which already incur high salaries and benefits expenses in relation to their revenue.

We made nine recommendations to ensure that SE’s Corporate and Retail groups improve their working relationship, transparency, and service to museum stakeholders.

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1 For the purposes of this report, we refer to the President and the Office of the CFO, which includes Accounting, Corporate Planning and Analysis, and Information Technology, collectively as Corporate.
BACKGROUND

SE Organization

SE comprises the majority of the revenue-generating operations of the Smithsonian Institution and is an essential source of its unrestricted funds. It operates three divisions of business activities: Retail, Media, and Consumer Products. SE’s Retail division (Retail) operates stores, theaters, concessions, and food and beverage venues inside the museums. It also operates the Smithsonian Catalog. Some of what Media manages includes SE’s two magazines – the Smithsonian Magazine and Air and Space Magazine – and the Smithsonian Network, a cable channel. Consumer Products generates revenue through licensing agreements, such as partnering with Subway and Kraft Foods, Inc. to leverage the Smithsonian name; and through Smithsonian Journeys, a museum-based educational travel program. Corporate provides support for Retail, Media, and Consumer Products.

The President is responsible for promoting efficiency and increasing income contributed to the Smithsonian.

SE decentralizes its financial management operations within the organization. Each division has its own staff that carries out distinct financial duties. The separate finance departments within the divisions report on a “dotted-line” basis to the CFO, which means that they work with the CFO regularly, but report directly to another individual.

Financial Results

Since fiscal year (FY) 2008, SE’s revenue has trended downwards, while its net gain has trended upwards. (Net gain is SE’s financial reporting terminology and is equivalent to net income, i.e., total revenues less total expenses.) See Table 1 below.

Table 1. Revenue and Net Gain trend since 2008, as reported in the Institution’s audited financial statements.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Revenue (in millions)</th>
<th>Net Gain (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$157.3</td>
<td>$26.7</td>
</tr>
<tr>
<td>2009</td>
<td>$155.2</td>
<td>$27.0</td>
</tr>
<tr>
<td>2010</td>
<td>$146.5</td>
<td>$27.8</td>
</tr>
</tbody>
</table>

In FY 2010, SE generated $146.5 million in total revenue, with Retail bringing in $81.2 million; Media, $57.6 million; and Consumer Products, $7.7 million. The Smithsonian shares a portion of Retail’s net gain (known as the revenue share) with museum partners. According to SE, the museums received approximately $10.6 million and $11.0 million in FYs 2009 and 2010, respectively.
SBV Task Force, SD 324, and the Revenue Share Model

In 2007, because of continued disagreement between the museums and what was then known as Smithsonian Business Ventures (SBV)\(^2\) over the revenue share, and other controversies relating to SBV,\(^1\) the acting Secretary established a Task Force to examine the existing SBV structure. In addition to examining revenue share methodologies, the Task Force was to consider the outsourcing of the museum stores. Ultimately, the Task Force recommended improvements to SBV’s structure and organization; ways to maximize its financial and program-related contributions to the Institution; a name change; that SBV maintain the museum stores under Smithsonian management; and a change to the revenue-share model to make it consistent throughout the Institution. The revenue-share model is the formula by which the Smithsonian distributes net gain between the museums and the central trust, which comprises the Smithsonian’s non-appropriated funds.

Prior to the Task Force, SBV had individual revenue-sharing agreements with each museum. The Task Force recommended that the Smithsonian replace these models with one standard formula. As a result, in January 2009 the Smithsonian issued a new policy, Smithsonian Directive (SD) 324, which requires that the museums and the central trust share net gain on a 50-50 percent basis.

SD 324 also describes roles and responsibilities for various stakeholders. The responsibilities of key personnel as they relate to our audit objectives are as follows:

- The Director of Office of Planning, Management and Budget (OPMB) is responsible for the revenue share methodologies and procedures.
- The SE CFO is responsible for the allocation methodology, producing P&L statements, and reviewing costs with stakeholders.
- The Retail Vice President\(^4\) is responsible for collaborating with museums on improving retail performance.
- The Smithsonian Under Secretaries and SE President are responsible for approving and recommending changes to the revenue share policy.

In addition, the Director of OPMB, along with SE managers, museum directors, and the SE CFO are collectively responsible for reviewing, questioning, and imposing retail performance.

\(^2\) One of the recommendations that came from the Task Force was to change the organization’s name from Smithsonian Business Ventures to Smithsonian Enterprises. The name change became official on July 1, 2008.


\(^4\) Since the issuance of SD 324, SE has changed this title to Retail Director.
discussing, on a regular basis, direct and indirect retail business costs and the methodologies used to allocate shared-service costs.

**Shared Service Allocations**

In computing net gain, SE must account for the cost of the central services necessary to operate and administer various retail activities in the museums. SE shows the distribution of these costs to the museums through P&L statements, which are individual income statements for individual stores, theaters, food and beverage, and concessions operations within a museum (called satellites). SE divides the costs into two types: corporate-shared services and divisional-shared services.

**Corporate-Shared Services**

Corporate-shared services are the costs allocated by Corporate to support the lines of business and include Accounting, Human Resources (HR), Management Information Systems (MIS), Office Management, and Reporting Systems.

SE allocates its corporate-shared services expense in a two-step process. In the first step, Corporate develops allocation percentages to distribute corporate costs to the lines of business. For example, SE uses the number of IT connections for MIS, time estimates for HR and Accounting, as well as other methods for the other departments. In the second step, SE allocates costs from the lines of business to the satellites in two different ways. For stores and theaters, SE bases the cost allocation on FTEs. For food and beverage, and concessions, SE bases the cost allocation on percent of revenue.

**Divisional-Shared Services**

Divisional-shared services are the costs associated with operating Retail, such as Retail management, finance, distribution, buying, and the like. SE also allocates the divisional-shared services in a two-step process. In the first step, Retail computes allocation percentages using various methods. For example, Retail bases its management percentages on projected revenue, and other percentages on the lines of business they support. Retail provides Corporate with these percentages, which Corporate then enters into the accounting system. In the second step, SE allocates divisional-shared services from the lines of business to the satellites the same way it allocates corporate-shared services. See Figure 1 for a graphical representation of how SE allocates costs.

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5As noted earlier, SE Retail has five lines of business: Stores, Theaters, Food and Beverage, Concessions, and Catalog.
Figure 1. Corporate- and Divisional-Shared Services Allocation Flow

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**SE’s Budget and Capital Appropriation Processes**

SE’s fiscal year ends on the last Saturday of September each year. SE begins its annual budgeting process in early March and finalizes it in July. During this process, all divisions work autonomously on their own budgets. The divisions then present these budgets to the CFO and President for review, discussion, and approval. In FY2010, the President approved the budget before presenting it to the Board of Regents Finance Committee at their August meeting.

Retail incorporates proposed capital projects for the upcoming year into its budget. To execute these projects, Retail must submit to Corporate a Capital Appropriation Request (CAR) form, which provides the financial analysis supporting the project. Corporate must review and sign the CAR form to authorize the project. As of FY 2011, SE also requires a museum executive to sign the CAR form.

**Conflict between Corporate and Retail**

There is a longstanding history of disagreements over roles and responsibilities between Corporate and Retail. These disagreements came into focus in November of
2009 when the President and CFO requested Retail management to sign a financial statement attestation letter. Retail management had concerns about the letter’s content and whether they had the obligation to sign the letter as written. Retail management did sign the letter, but included several caveats:

1. the role and responsibility of the Retail Division Financial Manager with respect to the financial statements required specific definition;

2. the stores’ financial reporting depends on systems and processes managed outside of the Retail Division’s internal control structure;

3. internal control deficiencies surrounding the systems and processes should be resolved; and

4. specific divisions could not attest to elements outside of their immediate control.

The President and CFO determined that the concerns were not material to the SE consolidated financial statements.

The President tasked SE executives with resolving the conflicts between their divisions, and assigned the Director of Human Resources to facilitate the meetings. The participants at the meetings developed a thirteen-point document (the 13-Point Plan), which highlighted specific points of concern between Retail and Corporate and set forth resolutions. For example, SE representatives discussed the unclear organizational structure, allocations by museum, the text of the attestation letter, and issues surrounding the accounting for Cost of Goods Sold (COGS). Some viewed the process as constructive, while others had less confidence in its effectiveness.

Again, in FY 2010, in discussions regarding the attestation letter, a Retail management employee indicated he would hesitate to sign the letter. His concerns centered on the presentation of COGS; payroll expenses; unbudgeted accounts; and the distortion of satellite profitability created by overhead allocation methods. The CFO and the Retail Director of Finance provided a joint response to the SE President to address the employee’s concerns.

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Generally, a financial statement attestation letter certifies that the signatory has no knowledge of fraud, conflicts of interest, material internal control weaknesses, material misstatements, or omissions in the financial statements.
RESULTS OF AUDIT

Lack of Collaboration between Retail and Corporate and Unclear Roles and Responsibilities Negatively Affect Service to Museums and Financial Profitability

We found that the collaboration between Corporate and the Media and Consumer Products divisions was generally effective. However, Corporate and Retail do not collaborate during the budgeting process, which often delays the implementation of budgeted capital projects or results in their cancellation. These delays or cancellations may lead to a loss of revenue and jeopardize relationships with museums. In addition, a lack of understanding of roles, responsibilities, and accountability regarding ownership of the allocation methodology and explaining financial information leads to poor service to some museums. Further, based on our interviews and the tenor of internal communications, we believe the lack of collaboration negatively affects employee morale.

We identified the following instances where the lack of collaboration between the two divisions adversely affected SE’s potential revenue growth.

- In its 2011 budget for the National Museum of the American Indian (NMAI), Retail included plans for a store consolidation in November 2010 and a café expansion in March 2011. Retail projected that the store consolidation would save approximately $139,000 in salaries and benefits. The café expansion stood to increase gross revenue by approximately $97,000 in FY 2011. The SE President approved the FY 2011 budget, which included these projects, in June 2010.

  In late October 2010, Retail submitted the CAR forms to Corporate to receive authorization for the capital projects. Corporate did not immediately approve the CAR forms because they lacked several elements, including an internal rate of return calculation; a net present value calculation; support for an increase in vendor revenue; and accurate COGS and gross margin percentages. In addition, Corporate requested that Retail open discussions with the third-party food and beverage vendor to modify an existing contract before it would authorize the café expansion project. Further, Corporate did not receive the CARs in enough time for Retail to execute the projects as budgeted. Consequently, SE delayed the projects. In so doing, SE will delay the time it takes for the café expansion to operate profitably.

  The lack of written procedures regarding the CAR submission process hampered collaboration between the two divisions. Written procedures help to enhance productivity and maintain continuity of operations. Further, we saw no evidence that the divisions worked together, in advance of the CAR submittal, to ensure the timely commencement of either project.
• In its FY 2010 budget request, SE included the addition of a theater at the National Museum of American History (NMAH). Though Retail’s expectation to open the theater was clear, the ensuing events were both costly and chaotic. Retail outsourced to a consultant to put together a business plan for the theater; however, we learned that the SE CFO disagreed with the assumptions in the business plan and concluded that the project was not economically viable. Though the museum was aware that SE was performing an analysis on the addition of a theater, they claimed that SE had not apprised them of the project’s inclusion in the budget until the annual directors’ meeting. Ultimately, the museum obtained private funding for the theater, resulting in the cancellation of the SE project. However, SE charged the museum with $115,000 in preliminary costs associated with the project, which affected the museum’s net gain. This series of events raises concerns about the internal deliberations across SE regarding capital projects and the extent to which SE as a whole is adequately coordinating its business planning process with its museum stakeholders.

Also, during several meetings with museum partners concerning Corporate-shared services, the museums questioned the financial benefits of the inventory systems and distribution centers consolidation. Corporate could not address their concerns because, they stated, they were waiting on Retail to provide the information. We question the practice of budgeting resources that support Retail initiatives without collaborating with Retail.

The lack of collaboration between Retail and Corporate is also a concern outside of the budgeting process. For example, SE does not have detailed financial procedures regarding the closing of satellites. During our review of the P&L statements, we noticed that SE had not written off assets from two closed satellite locations. Retail closed them over two years ago, but the P&L statements still reflected fixed assets for the locations. SE has since written off the assets, but because this did not happen sooner, the museum experienced an unexpected loss of approximately $27,000 in net gain in the second quarter of FY 2011. We could not determine why SE did not write off the assets at the time it took the satellites out of service.

Museum directors and personnel may occasionally request financial information from SE. Based on the various position descriptions we reviewed, it is unclear who is ultimately responsible for providing financial information to the museums. For example, we noted that the CFO position description states that the CFO is responsible for providing analysis and financial reporting to the museum directors. At the same time, the Retail Director of Finance’s position description states that he is responsible for preparing all financial reports and requests to and from museum partners. Furthermore, the Chief Operating Officer’s position description states that he is responsible for presenting operational financial results to museum directors.
The overlapping duties set forth in the position descriptions add to confusion over roles and responsibilities, and weaken the service provided to museums.

The Institution recognizes that collaboration is important to achieving its mission and revenue generating goals. The SBV Task Force stated, “The best opportunities to accomplish something interesting and/or significant at the Smithsonian involve collaborations with people who have other skills and other knowledge.” In addition, SE has incorporated collaboration as an element into its senior executive performance plans. An Outstanding rating requires that an executive “Encourages a work environment that accepts differences, builds trust, promotes open & honest communication without retribution, and effectively solicits, considers and, as appropriate, incorporates differing views to avoid non-productive conflicts” and “Accepts feedback and responds in a positive manner to ensure continued collaboration.”

Certain SE position descriptions identify roles and responsibilities as they pertain to the budgeting process. The Director of Retail is responsible for “developing and executing business strategies, capital investments, and programs and activities, which generate mission and non-mission related sales and profits.” His direct report, the Retail Director of Finance, is responsible for the budget process. The CFO is responsible for managing the process for the development and approval of annual operating and capital budgets as well as any strategic investments. He is also responsible for ensuring that appropriate line managers vet and execute revenue and profit initiatives.

Notwithstanding the 13-Point Plan, the unclear, overlapping, and ill-defined roles and responsibilities between Corporate and Retail continue to inhibit the working relationship between them. While the 13-Point Plan indicates that SE identified roles and responsibilities in organization charts and provided them to both groups, we note that organization charts do not set forth roles and responsibilities. Further, the confusion over the ownership of the allocation methodology that we discuss later in this report, and the continued disagreement between Retail and Corporate regarding attesting to the financial statements, show that SE has not effectively identified roles and responsibilities. We also found no evidence of SE updating any management position descriptions during the 13-Point Plan process. SE also has not addressed other issues, including:

- Allocations by Museum. The 13-Point Plan indicates that allocations by museum are not material to the sign-off on the attestation letters. However, in our opinion, it is unclear from the language of the attestation letter, which refers to “my organization,” whether the allocations are in fact material to sign-off. For example, it is unclear whether “my organization” refers to all of SE, divisions, the lines of business, or individual satellites.
• COGS. The 13-Point Plan indicates there were questions regarding how the inventory system interfaced with SE’s accounting system. The document then indicates that the matter is a work in progress, but lists this item as closed, effectively contradicting itself.

Some employees were disappointed with the outcome of the 13-point plan. In fact, one employee called the process a “complete failure.” The President takes responsibility for the continuing problems between Retail and Corporate, and recognizes the need to improve on the 13-Point Plan. He has hired an outside facilitator to address the fractured relationship between Corporate and Retail.

Finally, we note that the lack of collaboration over budgeting and execution of capital projects may be affecting Retail’s revenue. As of April 2011, as presented to the Regents’ Finance Committee, Retail’s forecasted revenue for FY 2011 is down $8.5 million from its budget. SE attributed the shortfall to lower consumer spending and poor catalog performance. We believe the continued disconnect between Corporate and Retail also contributes to Retail’s declining revenue and hinders its ability to maximize support for its stakeholders.

RECOMMENDATIONS

To promote collaboration between Retail and Corporate, and improve employee morale, we recommend that the President, SE:

1. Ensure the CFO and Director, Retail Division, in coordination with museum partners, collaborate on Retail’s capital projects. Both divisions should demonstrate their understanding of the benefits, costs, and time-lines associated with each project prior to its inclusion in the budget.

2. Formalize and implement procedures for store closings and Capital Appropriation Request submittals.

3. Modify attestation letters so they are specific to each division and more explicitly explain the extent of the attestations.

Transparency of Financial Information SE Presents to Museums Could be Improved

SE presents financial information to museums in various ways: at an annual directors’ meeting open to all directors of museums with SE retail operations, at annual museum budget meetings, at quarterly museum operating reviews, and through monthly P&L statements. However, SE does not fully comply with SD 324 or meet the spirit of the Task Force report. In fact, several museums told us that they did not understand the overhead costs or allocation methodology.
SD 324 guides the interaction between the Smithsonian, SE, and museums. It states that the SE CFO is responsible for:

- participating with SE managers and museum directors to collectively review, question, and discuss – on a regular basis – direct and indirect retail business costs and the methodologies used to allocate shared service costs, and

- producing monthly P&L statements by retail activity to each museum location and coordinating with the SE Retail Vice President for communication to the museums.

These provisions implement the January, 2008 SBV Task Force report recommendation that:

To the extent feasible, without impeding performance or compromising contractual obligations, the rationale for decision-making, the operational structure, and performance information about business activities should be clear and accessible to those internal Smithsonian stakeholders who need to understand it.

At the October 12, 2010, annual directors' meeting, which included museum directors and Smithsonian management, SE reported an estimated net gain of $26.0 million for the year just ended, as of September 25, 2010. However, SE's income statement as of September 25, 2010 and closed on October 19, 2010, showed a net gain of $27.8 million. In reporting the estimated net gain for the year at $26.0 million, SE relied on financial data from June 2010 rather than actual net gain amount as of September 25, 2010. As a result, SE's presentation understated the net gain at year-end by $1.8 million. SE explained that they confirmed the general accuracy of the financial information presented at the directors' meeting, using a late September outlook.\(^7\) We reviewed these figures, and noted that they were within approximately $500,000 of the June projection.

In the FY 2011 budget, SE showed an expected increase in net gain of 8 percent, or $2.2 million. Had SE used the actual net gain amount at the close of the fiscal year, rather than the outdated estimate, the projected increase in net gain would have been 1.4 percent, or $400,000. Understating the financial performance for the year thus served to reduce the baseline against which to measure the projected financial performance for the next year. We question why SE reported these June forecasted numbers for an October meeting, 17 days after the fiscal year end, when more recent financial data were available.

\(^7\)An outlook is a monthly projection of SE’s financial performance.
We noted that the presentation materials for the prior year directors’ meeting dated September 22, 2009 also understated actual financial performance for the previous year. SE forecasted a net gain of $25 million, with a footnote stating that net gain would be between $25.5 and $26 million; however, the actual net gain was $27 million. SE also presented the FY 2010 budgeted net gain of $25 million. Had SE used the actual net gain figure, it would have appeared that it was budgeting for a decrease of $2 million, or seven percent, in net gain for FY 2010. We found no compelling reason why SE conducts the annual meeting prior to the close of the fiscal year. In the interest of transparency, we believe if SE cannot provide more accurate net gain estimates, it should conduct the annual directors’ meeting only when the actual financial performance is known.

In addition, we do not believe the directors’ meeting allows for a sufficient, collective discussion between SE and the museums. Based on our observations at one such meeting, SE allotted a small amount of time for only a high-level review of overhead costs. We also noted that SE has not provided museum directors an annual report for all of SE.

In addition to the annual directors’ meeting, SE Corporate and Retail management did independently visit most museums to explain their cost structure and budgeted financial information. However, Corporate presented to only five of nine stakeholders, and Retail presented to only seven. They both excluded the National Museum of African Art (NMAfA) and the National Postal Museum (NPM), while Corporate also excluded the Hirshhorn Museum and Sculpture Garden (HMSG) and NMAI. We discussed transparency with all museum partners and learned additionally that NMAfA and NPM do not receive monthly P&L data, nor do they meet with SE to discuss their quarterly operating results. According to Retail, historically, these museums have not been interested in hearing about their financial results. However, we spoke with a representative from NMAfA, who stated that he would welcome any information on the financial performance of his museum store and that he was unsure if the museum was receiving any revenue share. He stated that he never knew whom to contact about receiving financial information and had stopped attempting because of his lack of success in the past. We confirmed this by viewing internal communications from Corporate to Retail in November of 2009, where Corporate notified Retail that NMAfA was interested in their revenue share and P&L data. We also viewed the monthly P&L distribution list, which did not include NMAfA. NPM expressed to us that it is not interested in learning more about the museum’s financial performance because it does not receive any revenue share and as such, does not believe meeting with SE regarding financials is a good use of its time.

In addition to excluding two of the smallest museums, Corporate did not meet with HMSG or NMAI, although SE had planned to conduct major renovations in both museums. HMSG is in the process of moving its Retail store to the lower level of the
museum, at a cost to the museum of approximately $241,000. As we described previously, SE delayed the major changes to NMAI’s retail operations. The renovations there are to cost approximately $296,000.

Corporate told us that they had considered following up with NMAI and HMSG after the Directors’ meeting. However, this follow-up never occurred. Considering the financial implications of the renovations, we believe Corporate should meet with these museum partners.

Moreover, the annual budget meetings happen only after SE has finalized its budget for the coming year, which suggests that SE is not seeking museum input. Indeed, one museum mentioned that any questions it has during this meeting are moot. Furthermore, this museum also believes that the quarterly operating reviews do not allow them to review, question, and discuss costs, as prescribed in SD 324. We believe meeting with and providing financial information to some museum partners, while excluding others, demonstrates preferential treatment and is not sufficiently transparent. If SE were to engage its museum partners earlier in the budgeting process, it could bring more transparency to the process and more productively collaborate in the spirit of the Task Force recommendations and SD 324.

Another instance of less than full transparency to museums is an accounting practice where SE offsets the divisional-shared service expense with beverage revenue. The practice of offsetting costs with unrelated revenue does not affect the net gain to the museums, but constitutes a careless accounting practice. SE states this practice eases processing; however, it results in P&L statements that are unclear. For example, in some cases, because the beverage revenue was higher than the divisional-shared service expense, the presentation on the FY 2010 P&L statements gave the appearance that the divisional-shared services actually earned money for food and beverage operations within the museums.

Last, SE’s P&L statements could be more transparent. SE presents corporate- and divisional-shared services as two summary line items, rather than showing the detailed costs that make up each. Without the detail behind the summary line items, the museums cannot effectively understand SE’s costs, nor are they in a position to make informed inquiries about them. Offsetting divisional-shared services with contract revenue, and summarizing corporate- and divisional-shared service costs, obscure the presentation of museum profit and loss. If SE displayed the costs by supporting function on the P&L, such as “accounting” or “distribution,” it would increase the transparency of the P&L to museum partners and allow the museums to better understand, question and discuss costs in accordance with SD 324.
RECOMMENDATIONS

To foster greater transparency in its financial information, we recommend that the President of SE:

4. Ensure that net gain information presented at the annual directors’ meeting is timely and accurate.

5. Prepare and distribute an annual report for all stakeholders that sets forth all of SE’s revenues and costs, and meet with museum partners to determine what additional information SE should include in the report.

6. Direct the CFO and Director of Retail to meet jointly with each stakeholder during the annual budget process to discuss both corporate- and divisional-shared services.

7. Provide the detail for corporate- and divisional-shared service expenses in the museum P&Ls, and discontinue the practice of offsetting costs with unrelated revenue in the P&Ls.

SE's Allocation Methodology May Not Fairly Distribute Costs

We believe the way SE allocates its overhead costs may not fairly distribute costs to its stakeholders. SE uses budgeted numbers to calculate fixed allocation percentages, does not directly charge identifiable costs, and uses a questionable cost basis, all of which result in some lines of business being under-charged at the expense of others.

SD 324 states that the CFO is responsible for ensuring that the method for allocating divisional- and corporate-shared services is documented and results in a fair, reasonable, and consistent allocation of these costs across all retail activities. It also states the Director of Retail is responsible for collaborating with museum personnel on matters related to continually improving retail activity performance.

As a best practice, SE should allocate costs using the following methods listed in order of preference: (a) directly tracing costs wherever feasible and economically practicable, (b) assigning costs on a cause-and-effect basis, or (c) allocating costs on a reasonable and consistent basis.\(^6\)

When SE does not execute a budgeted project, the museums may not realize the full amount of any cost avoidance associated with the project not going forward because SE allocates using budgeted costs. For example, Corporate included resources to

support the inventory systems and distribution centers consolidation in its FY 2011 accounting budget at a budgeted cost of approximately $113,000. Corporate passed the anticipated cost of the project along to the Stores and Catalog lines of business through a 2.3 percent increase in the accounting overhead calculation. SE informed us that this consolidation would not take place in FY 2011, but did not adjust its allocation percentages. By not going through with the consolidation in FY 2011, Stores and Catalog will forego approximately $61,000 in cost avoidance from the cancelled project. A fairer approach to allocating project costs would have been to directly charge the consolidation costs to the lines of business.

The complexity of the allocation methodology contributes to the lack of transparency in SE’s overall presentation of financial data on P&Ls. SE allocates its corporate-shared service costs in different ways. For example, SE allocates accounting costs to the lines of business using invoice activity for accounts payable, time sheets for payroll, accounting units for depreciation, and so on. Further, SE allocates MIS costs using the number of IT connections, as well as budgeted level of effort. SE has not provided written guidelines to the museums that describe in detail its methodology for allocating overhead. While museums understand that there is a cost of doing business, based on our discussions, the methodology is still unclear to them. One museum director described SE’s overhead allocations as “shrouded in mystery.”

We disagree with the use of FTEs to allocate overhead charges because most of the allocated costs do not have a causal relationship to FTEs. That is, the corporate- and divisional-shared services provided to the museums, such as distribution, buying, and information technology, generally are unrelated to, and do not vary with, the number of people they employ. We do agree that museums consume such services as human resources support and payroll proportionate to the number of FTEs. However, we estimated such service represented approximately $477,000 of the $6.4 million, or only 7.5 percent, in overhead charges to the Stores in 2010.

Several Retail personnel with experience at other major retailers, including the then Director, report that they do not believe FTEs are an appropriate cost basis; they believe percent of revenue would be more appropriate.

Allocating overhead charges from the lines of business to the satellites using FTEs also adversely affects smaller museums because the FTE methodology penalizes museums that have a higher ratio of labor costs to revenue. That is, in general, smaller museums do not generate revenue relative to the number of FTEs with the same success as the larger museums. Because of economies of scale, museums with larger

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9 According to SE, there were other costs, including information technology costs, budgeted for this project. For the purposes of our example, however, we used only the costs from the accounting budget.
revenue enjoy a higher return on investment from their workforce than smaller museums. Thus, the overhead charges to the smaller museums reduce their operating income disproportionately when compared to larger museums. Figure 2 compares the National Air and Space Museum (NASM), the museum with the largest revenue, and the National Postal Museum (NPM), the museum with the smallest revenue.

Figure 2. Relationship between overhead as a percent of revenue, salaries and benefits expense as a percent of revenue, and revenue earned per average FTE for NASM and NPM in FY 2010.

<table>
<thead>
<tr>
<th>Sales and Benefits</th>
<th>NASM Stores</th>
<th>NPM Store</th>
<th>Calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>$13,027,822</td>
<td>$254,203</td>
<td>(A)</td>
</tr>
<tr>
<td>Total Overhead</td>
<td>$1,600,672</td>
<td>$99,997</td>
<td>(B)</td>
</tr>
<tr>
<td>Total Salaries and Benefits</td>
<td>$1,423,706</td>
<td>$125,355</td>
<td>(C)</td>
</tr>
<tr>
<td>% Total Overhead to Total Revenue</td>
<td>12.29%</td>
<td>39.34%</td>
<td>(B)/(A)</td>
</tr>
<tr>
<td>% Salaries and Benefits to Revenue</td>
<td>10.93%</td>
<td>49.31%</td>
<td>(C)/(A)</td>
</tr>
<tr>
<td>Average FTEs</td>
<td>41.03</td>
<td>3.31</td>
<td>(D)</td>
</tr>
<tr>
<td>Average Revenue per FTE</td>
<td>$317,519.42</td>
<td>$76,798.49</td>
<td>(A)/(D)</td>
</tr>
</tbody>
</table>

Discussions regarding the use of FTEs go back to the inception of the methodology. One former Retail Director of Finance stated:

Retail’s two biggest allocated costs are distribution and buying. Logically, these costs are dependent upon the volume of merchandise flowing into a location. As such I believe that allocating these costs based on FTEs will penalize smaller stores to the benefit of the larger stores.

In addition, another former Retail Director of Finance stated:

Regardless of the fact that the FTE system is applied consistently, SE spends an inordinate amount of time explaining and justifying the current allocation system. Small shifts in staffing can lead to large allocation swings, which appear dubious compared to location revenue.

We identified a large allocation swing in the second quarter of 2011. The analysis below demonstrates how a shift in FTEs led to this change and negatively affected NMNH. This happened because NMNH’s FTEs remained constant compared to its budget, while other museum FTEs were fewer than budgeted.
First, the reduction in FTEs for NMAH and NASM saved those museums approximately $184,000 and $111,000 in budgeted overhead, respectively. However, because SE did not reduce staffing at NMNH stores, it did not experience similar savings; rather, its overhead increased by approximately $10,000 more than what was budgeted. Second, NMNH’s 2011 actual overhead increased by approximately $104,000 from the same period in 2010, yet NMAH and NASM experienced only modest increases.

Significant allocation swings compared to revenue also appear in NASM’s revenue through the second quarter of 2011, which was approximately $900,000 (or 26.5 percent) higher than NMNH’s revenue for the same period. However, NASM’s overhead is about $12,000 (or 1.5 percent) lower than NMNH’s overhead. Because of the allocation swing, NMNH’s net gain was down about $163,000 for stores, whereas its operating income was down only about $60,000.

Using FTEs as a cost basis has been a longstanding concern within SE Retail. We believe the use of FTEs as a cost allocation basis may be inappropriate because of the lack of causal relationship FTEs have with the majority of the costs, the disproportionate effect it has on small museums’ operating income, and the large allocation swings that can occur from even minor shifts in staffing.

**RECOMMENDATIONS**

To ensure greater transparency and a more effective use of resources, we recommend that the President of SE, in coordination with the Director of the Office of Planning, Management, and Budget, and Museum Directors:

8. Evaluate the allocation methodology, particularly the cost basis for stores and theaters, and modify it as appropriate.
To ensure greater transparency regarding SE’s costs and allocation methodology, we recommend that the President of SE:

9. Document the agreed-upon allocation methodology in a clear manner for museum partners to understand, including justifications for the cost bases and support for all SE lines of business percentages used.

MANAGEMENT COMMENTS

The President of SE provided formal written comments to our draft report on August 19, 2011. SE generally concurred with eight of our nine recommendations; however, SE disagreed with many of the key findings that lead to the recommendations. Below, we summarize their comments and offer our responses.

First, SE agrees that it could improve collaboration between the Retail and Corporate divisions. However, they disagree that there are unclear roles and responsibilities and strongly disagree that the examples we provided in our report demonstrate a reduction in the financial profitability of the museums.

Second, SE agrees that it could improve transparency, but disagrees that it has not provided information in a timely and accurate manner, or does not allow sufficient time to discuss results and answer questions.

Third, SE believes that its allocation methodology is reasonable.

In addition, SE took exception to our inclusion of survey comments in our report because they believe some comments were influenced by other SE employees.

The President of SE proposed the following actions to address our recommendations:

- By September 30, 2011, SE Corporate and Retail groups will jointly complete all museum budget review meetings to discuss capital projects. In addition, SE management will write and implement procedures for store closings and Capital Appropriation Request submittals. Furthermore, SE will provide the detail for corporate- and divisional-shared service expenses in the museum P&Ls, and will discontinue the practice of offsetting costs with unrelated revenue in the P&Ls.

- By February 28, 2012, SE will consult with the SE Strategic Advisory Committee, and prepare and distribute an annual report to all stakeholders.

- By March 31, 2012, SE will consult with the SE Strategic Advisory Committee for questions and advice on presentation of the allocation method and details.
• By May 31, 2012, SE will evaluate the allocation methodology and modify it as appropriate. SE will task its incoming Retail Director to evaluate and recommend an alternate approach for implementation in FY 2013.

• By September 30, 2012, SE will move the annual museum director meeting to March/April. This move will allow SE to include and present the final audited financial results, as well as allow the directors an opportunity to provide input on their budget. SE will hold additional meetings with the museums to further review and collaborate on the budget. In addition, the SE CFO and Retail leadership will continue to meet with museums, and refine the process to discuss operational matters and overhead.

Finally, the President of SE does not concur with our recommendation to modify the current attestation letters to specify the division and more explicitly explain the extent of the attestation. According to the President, SE cannot alter its annual attestation letter; however, SE will ensure that all employees required to sign the letter attend an overview presented by the Smithsonian’s Office of the Comptroller (OC) on internal controls and the attestation process. The target date for the OC internal controls overview is June 30, 2012.

We include the full text of SE’s response in Appendix B.

OIG COMMENTS

We are pleased that SE agreed to improve collaboration between the Corporate and Retail divisions, as well as the transparency of financial information to museum partners. Below, we clarify the intent of several of our recommendations, and address Management’s general comments on the report and disagreements with the findings.

For recommendation 8, SE stated it will review all allocation methodologies and percentages and will rely on its new incoming Retail director to evaluate and recommend an approach for the FY 2013 budget process. Concerning recommendation 9, SE states it will consult with the SE Strategic Advisory Committee for questions and advice on presentation of the allocation method and details. When we follow up on SE’s implementation of these recommendations, we will be looking at the evidence of SE’s reviews and consultations. Therefore, we would like to emphasize to the importance for SE to keep a written record.

SE did not concur with our recommendation to modify attestation letters so they are specific to each division and more explicitly explain the extent of the attestations. SE claims that OC does not allow them to alter its annual attestation letter. According to the Comptroller, however, the Smithsonian’s Office of the Chief Financial Officer (OCFO) only requires attestation letters from the SE President and CFO. The Comptroller concurred that SE cannot modify these attestation letters. However, the
Comptroller further stated that the SE President could modify any additional attestation letters that he requires for his own internal documentation, as SE is not required to submit these to the OCFO. We will continue to work with SE to resolve this recommendation.

In their general comments, SE did not agree that roles and responsibilities are unclear. However, based on our interviews with SE personnel, we encountered confusion over roles and responsibilities with some staff.

SE stated that it does not believe that our examples demonstrate a reduction in financial profitability of the museums. We would like to emphasize that, in the case of NMAI, a lack of written procedures surrounding the CAR process was a contributing factor to the project’s delay, which resulted in reduced profitability for the museum.

Furthermore, while SE believes that the $115,000 in preliminary costs for the NMAH Carmichael theater were not unusual in relation to what would have been a $2-3 million investment at the museum, the costs totaled approximately 5 percent of the museum’s total net gain for the year. The five percent loss may not be significant for an investment of this size; however, it was significant for the museum.

Concerning transparency, SE disagreed that it did not provide information to museums in a timely and accurate manner. Although SE claimed to have discussed 89 percent of its overhead costs with museums, they still did not visit four of the nine museums to discuss the corporate-shared service structure.

SE did not agree with what it called our “hypothetical” statement that their allocation methodology may not fairly distribute costs. SE asserted that it has allocated costs on a reasonable and consistent basis since FY 2005. However, as outlined in our report, we believe the methodology is unreasonable given the fact that costs are distributed using an allocation base that is generally unrelated to the costs.

SE stated that it did not concur that it should alter its allocation method to accomplish distribution outcomes that benefit one museum over another. The comment misrepresents our position. We do not recommend that SE adopt allocation changes to accomplish distribution outcomes. Nor did we state that the Retail director had proposed a revenue-based allocation scheme.

Regarding the inclusion of our survey results, we excluded all mention of survey comments in our report because we did not rely on them to support our findings and recommendations.

We appreciate the courtesy and cooperation of SE staff during the course of this audit.
APPENDIX A. SCOPE AND METHODOLOGY

The objectives of the audit were to determine whether the SE CFO: (1) has collaborated with division management to accurately and timely report financial data; (2) provided transparent accounting services to museum partners; and (3) established clear roles, responsibilities, and lines of accountability. We also assessed employee morale as it relates to financial management operations.

Although the objectives relate specifically to the Office of the CFO, we reviewed the collaboration, transparency, roles, responsibility, accountability, and employee morale of all SE divisions, with a focus on Corporate and Retail.

As a foundation for planning and for establishing criteria, we reviewed prior audits involving SBV; several SDs that pertain to SE operations, including SD 324; and the SBV Task Force Report issued January 28, 2008. We also reviewed the position descriptions and performance plans for relevant positions, as well as pertinent accounting standards and internal financial policies.

To determine whether divisions collaborate internally and with other divisions, we interviewed the Directors of each division and key personnel within Retail and Corporate. We also reviewed financial documentation and internal communications provided to us by SE personnel.

To confirm whether SE was providing transparent accounting services to museum partners, we: (1) attended a meeting that SE held with the museum directors; (2) attended a meeting that Retail held with a museum partner; (3) met with representatives from all museums that have an SE presence; (4) reviewed documentation, such as time studies and internal calculations, related to the allocation and revenue share methodologies; (5) interviewed SE executives and staff with retail responsibilities; and (6) examined SE financial data, including museum P&L statements, budgets, and forecasts.

To verify that SE had established clear roles, responsibilities, and lines of accountability, we interviewed key personnel and reviewed position descriptions and performance plans. We also reviewed SE’s summary of the 13-Point Plan meetings.

To assess employee morale and receive feedback on the objectives of the audit, we distributed a web-based survey to a group of SE employees in which we covered collaboration, transparency, accountability, and individual and overall employee morale. However, because SE alleged the survey results were coached, we did not rely on the survey results and assessed the employee morale objective by using the other methods described herein.

We conducted this performance audit in Herndon, VA and Washington, D.C. from September 2010 to May 2011 in accordance with generally accepted government
auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.
Date: August 19, 2011

From: Tom Ott, President, Smithsonian Enterprises

To: A. Sprightley Ryan, Inspector General

Cc: Carol LeBlanc, Vice President, Smithsonian Enterprises
    Greg Bokman, Chief Financial Officer, Smithsonian Enterprises
    Kenneth Johnson, Acting Director, Office of Planning, Management, and Budget

Subject: Response to the Report on Smithsonian Enterprises Financial Management Operations, Number A-10-12

Smithsonian Enterprises (SE) appreciates the opportunity to respond to the Report on Smithsonian Enterprises Financial Management Operations, Number A-10-12. We welcome the majority of recommendations, which we are in position to implement, and have detailed the actions taken to date and target dates for completion. We do not, however, concur with many of the key findings and perceptions that form the background that leads to the recommendations.

We would like to now respond to the lead opinions from the OIG as well as address the various recommendations that flow from those opinions.

1. OIG opinion: Lack of collaboration between Retail and Corporate and unclear roles and responsibilities negatively affect service to museums and financial profitability.

   SE Response: SE concurs that collaboration can be improved between the Retail and Corporate functions. SE does not agree that there are unclear roles and responsibilities and disagrees strongly that the examples provided demonstrate a reduction in the financial profitability of the museums.

   We agree that the Retail and Corporate groups can and should collaborate more effectively, and along with internal actions to support this, we have also engaged an outside facilitator to further assist our goal of stronger collaboration.

   SE has provided position descriptions for all personnel requested by the Inspector General. We disagree that overlapping responsibilities are an issue as this is a requirement of an organization with decentralized financial managers with shared accounting and financial planning resources.
SE’s primary mission is to improve the profitability of the business operations and ensure the best possible return on its commercial investments, while at the same time complying with individual museums’ strategic and mission requirements. We believe the two examples cited to indicate SE “negatively affect services to museums and financial profitability” actually demonstrate the positive impact that SE’s oversight provides.

The Mitsitam Café expansion and Chesapeake Store consolidation at the National Museum of the American Indian was initiated in October 2010 and finalized in February of 2011. The store consolidation, which required no capital, was never at issue, but SE believes it was prudent to examine all revenue generating options for this valuable space.

The subsequent negotiation with the subcontractor, as recommended in the capital process by SE Corporate, led to a $33K or 10% reduction in the project cost and also represented approximately 1/3 of the expected revenue benefit of the project in the first year ($97K of gross revenue). We believe this mitigated the risk to the museum and improved the return on investment.

The potential for a theater at the National Museum of American History was investigated as far back as 2007 and SE did incur consulting fees (the $115,000 stated in the report). The decline in theater performance on the Mall due to industry trends, increased competition, overall economic conditions, and the lack of compelling and unique mission film content marginalized SE’s view of the potential return on this project in early 2010. The museum’s stated intent to convert this space to a film exhibition area and success at funding the construction through donations led to, in our view, the correct decision to terminate this project utilizing Smithsonian capital funds. We also believe that the level of preliminary costs was not unusual in relation to what would have been a project of $2-3 million of investment.

We take issue with the statement that “Retail’s forecasted revenue for FY 2011 is down $8.5 million from its budget. SE attributed the shortfall to lower consumer spending and poor catalog performance. We believe that the continued disconnect between Corporate and Retail also contributes to Retail’s declining revenue and hinders its ability to maximize support for its stakeholders.”

SE attributed the shortfall to Catalog, not as opinion, but based on financial statements. SE’s Catalog operation is being restructured to de-emphasize unprofitable print catalog sales and refocus on profitable online sales directly leading to $5.7 million lower revenue with limited impact on profit. In addition, the lack of available and suitable retail space at a transportation hub has contributed another $0.8 million of this shortfall. Neither of these sales shortfalls impact museum funding. General economic conditions and theater performance have also contributed to the revenue performance. We would emphasize that SE in total has met or exceeded its budgeted net gain to the Institution since FY 2008 and grown this level of funding through some very difficult conditions.
OIG Recommendation 1: Ensure the CFO and Director, Retail Division, in coordination with museum partners, collaborate on Retail’s capital projects. Both divisions should demonstrate their understanding of the benefits, costs, and timelines associated with each project prior to its inclusion in the budget.

SE Response: SE concurs with this recommendation.

The SE Retail Group and SE CFO are in the process of meeting with the museums to review their overall FY 2012 budgets, including detailed capital projects affecting the individual museums’ retail operations. SE currently budgets capital projects with expected investment and expense and planned in-service dates. The related benefits and costs are budgeted by specific location and account. SE has solicited feedback from its museum partners on the planned capital projects as part of these meetings. The target date for completion of museum review meetings is September 30, 2011.

____________________________________

OIG Recommendation 2: Formalize and implement procedures for store closings and Capital Appropriation Request submittals.

SE Response: SE concurs with this recommendation.

SE currently has monthly and annual processes where its financial statements are reviewed and approved by the relevant division financial manager. Fixed asset balances are included in these reviews. Written procedures are currently being developed that will specifically address these two processes. The target date for completion of procedures is September 30, 2011.

____________________________________

OIG Recommendation 3: Create attestation letters that are specific to each division and more explicitly explain the extent of the attestations.

SE Response: SE does not agree with this recommendation.

SE utilizes the attestation letters provided by the Smithsonian Institution and requires key management to attest to these specific disclosures. As a best practice, SE has pushed this attestation lower within the organization and although all key managers have signed this attestation letter for FY 2010, SE encourages more junior staff to specifically identify and document any concerns or questions in their preferred format. Potential concerns or questions are not only followed up internally, but also are reviewed with the SI CFO and SE President for independent review.

In consultation with the SI Office of Comptroller, SE is not permitted to alter its annual attestation letter, but will ensure that all signatories are required to attend the overview to be presented by the Institution’s OC group on internal controls and the annual attestation process to have any questions addressed. The target date for completion of full attendance at OC overview on internal controls is June 30, 2012.

____________________________________
II. OIG opinion: Transparency of financial information SE presents to museums could be improved.

SE Response: SE concurs with this finding in that transparency can always be improved. We disagree that SE has not provided information in a timely and accurate manner or does not allow for sufficient time to discuss results and answer questions.

SE has implemented all SBV Task Force recommendations in this regard. SE’s process includes the following efforts to provide transparency:

- Provides monthly financial statements by museum showing all direct and indirect costs charged to the museum with prior year, budget, and latest forecast data. This is by individual location to the individual merchandise cart or store level.

- Quarterly financial reviews are held with the individual museums to review these results, answer questions, take actions, and discuss operational improvement.

- Annual budget process solicits museum input on visitation expectations, major exhibitions, and construction projects at inception.

- Museum-level budget presentation detailing financial statements for budget including capital and overheads.

- Specific overhead meetings detailing the process and details of indirect costs by museums which includes benchmarking and major initiatives planned. These were instituted by SE in 2009 at the largest museums with the most overhead and as of 2010 covered 89% of all overhead. SE agrees that going forward these will be expanded to all museums that have an interest in reviewing this information.

- Annual museum director’s presentation providing a two hour executive briefing on the state of SE’s businesses and major initiatives and strategies.

SE has commented previously that the museum director meeting has been scheduled in September and October to be as early in the fiscal year as possible. The meetings in FY 2009 and FY 2010 were held prior to the financial closing of SE’s books utilizing forecasted results and were the most accurate information available for the level of detail required at this meeting.

OIG Recommendation 4: Ensure that net gain information presented at the annual directors’ meeting is timely and accurate.

SE Response: SE concurs with this recommendation.

SE would reiterate that its meeting with museum directors in the past has occurred prior to the completion of its year-end process and all current year information has clearly been identified as a forecast and is the most accurate available. In order to comply with the IG recommendation that the actual results are provided within this meeting, SE will move the annual museum director meeting into the March/April timeframe to allow the final audited results be provided as
part of this review. This will additionally enable SE to solicit museum input prior to its FY 2013 budget process and allow for a more open discussion pertaining to budgeting for the following fiscal year. Additional individual museum meetings will be held during the summer to review and further collaborate on the output of the SE budget process. The target completion date is September 30, 2012.

_OIG Recommendation 5: Prepare and distribute an annual report for all stakeholders that sets forth all of SE’s revenues and costs, and meet with museum partners to determine what additional information SE should include in the report._

**SE Response: SE concurs with this recommendation.**

SE currently reviews its annual performance directly with the SI Office of the Chief Financial Officer and Regent’s Finance Committee. SE will consult with its Strategic Advisory Committee comprised of museum representatives for input on requirements and issue an annual report for FY 2011. The target completion date is February 2012 to permit final audited results to be included.

_OIG Recommendation 6: Direct the CFO and Director of Retail to meet jointly with each stakeholder during the annual budget process to discuss both corporate- and divisional-shared services._

**SE Response: SE concurs with this recommendation.**

SE continues to meet with its museum partners to review operational matters and overhead jointly with the SE CFO and Retail leadership. This process will continue for the FY 2012 budget and will continue to be refined as part of the FY 2013 planning processes as appropriate. The target completion date is September 2012.

_OIG Recommendation 7: Provide the detail for corporate- and divisional-shared service expenses in the museum P&Ls, and discontinue the practice of offsetting costs with unrelated revenue in the P&Ls._

**SE Response: SE concurs with this recommendation.**

Effective with the September 2011 close, SE will change the presentation of corporate- and divisional-shared service expenses in the museum P&Ls to detail the specific individual cost centers. Beverage revenue has always been recorded in revenue accounts and presented appropriately on the SE consolidated P&L as well as the SE Food & Beverage consolidated results. The OIG comment is specific to Museum P&L presentation only. The presentation of these beverage pouring rights referenced in this comment constitute 2.1% of total Food & Beverage revenue in FY 2010. For purposes of Museum P&L presentation, the beverage pouring rights are no longer recorded to a cost center with divisional shared services expense. This past practice had no impact on museum revenue share.
III. OIG opinion: SE’s allocation methodology may not fairly distribute costs.

SE Response: SE does not agree.

We strongly disagree with this hypothetical statement. SE has allocated costs on reasonable and consistent basis under the same basic system since FY 2005. SE reviewed the Statement of Federal Financial Accounting Standards Number 4, as footnoted on p. 15 of the report and found that it substantiates this method as an appropriate method to assign costs. We have included the text of this statement as relevant to current SE process (Appendix A).

SE does not concur that it should alter its allocation method to accomplish distribution outcomes that benefit one museum over another. The SBV Task Force recommendation adopted by the Institution to form a consistent revenue share policy providing 50% of profit to the museum and 50% to the central SI trust had various impacts on individual museum revenue share amounts. SE has provided multiple recommendations to the Institution to potentially deal with preferred distribution outcomes including:

- Vary the 50/50 formula to a higher percentage for smaller, less profitable locations.
- Provide a pool of funds from larger museums and the central trust from revenue generating activities to fund small museums.
- Greatly simplify the process by eliminating indirect cost allocations completely and establish a percentage of revenue share after direct location costs only.
- Pool all funds from revenue generating activities and fund projects or exhibitions on financial merit and alignment with SI’s strategic plan.

SE is open to any changes in its allocation systems that are documented, explained, and represent a more accurate view of profitability by location. SE reviews the allocation basis and percentages on an annual basis and provides all cost managers the opportunity to review the methodology and the common denominator used to allocate these costs. Opinions expressed by former employees or changes founded on improving one museum’s funding over another are not actionable by SE. The Retail director is afforded the opportunity to propose changes to all aspects of the allocation routines during the annual budget process. We disagree that a revenue-based allocation scheme has been proposed from the Retail director as this was covered specifically with executive discussions with the IG and documented in budget e-mails and the 13 Point Plan.
OIG Recommendation 8: Evaluate the allocation methodology, particularly the cost basis for stores and theaters, and modify it as appropriate.

SE Response: SE concurs with this recommendation.

SE reviews all allocation methodologies and percentages on an annual basis and reviews and adjusts the next fiscal year for input from the responsible cost leaders when documented and appropriate rationale is provided. SE has reviewed the annual approach to allocation review with the SI CFO and will rely on its new incoming Retail director to evaluate and recommend an approach for the FY 2013 budget process for implementation. The targeted completion date is May 2012.

OIG Recommendation 9: Document the agreed-upon allocation methodology in a clear manner for museum partners to understand, including justifications for the cost bases and support for all SE lines of business percentages used.

SE Response: SE concurs with this recommendation.

SE reviews the method and details of the cost allocations as part of the annual museum budget reviews and at an executive level at the museum director reviews. In addition, SE responds to clarifications and questions as they arise. SE will additionally consult with its Strategic Advisory Committee for questions and advice on presentation. The targeted completion date is March 31, 2012.

Additional comments

Staff survey inclusion

We would like to express our disappointment at the inclusion of the survey with corresponding analysis and selected comments. We were provided with one comment from the IG indicating that “coaching” had occurred, which was corroborated by several executives within SE. Although no major findings or recommendations flow from this survey, we believe that selecting comments for inclusion in a public document based on a flawed survey methodology with choreographed responses does not appropriately represent the standards of the Smithsonian Institution.

Below is the comment provided by the Inspector General in regards to the OIG employee survey and potential coaching.

"I need to mention that I was asked if I received this survey and was told that if I did that they would be glad to "coach" me on my answers. I think that was totally inappropriate; but it is very representative of the way things have been handled in the past. There was an email that was sent out at one point eliciting negative feedback specifically about Corporate Finance. It actually coached people and gave examples of what they want to see."
Appendix A – Allocation Process as it Relates to Federal Standard
Statement of Federal Financial Accounting Standards Number 4

The Statement certainly identifies the concept of assigning costs on a cause and effect basis but also indicates two other appropriate methods with Item (c) being “allocating costs on a reasonable and consistent basis.” Factually, SE’s methodology is viewed as one of the three appropriate methods in this Statement. We did not find a requirement in this Statement that would require SE to assign costs that “FTEs do, in fact, have a causal relationship with the majority of the allocated costs” per your request.

In fact, the Statement supports the concept that there may be shared costs, which are commonly used by various segments, which might not be economically feasible to directly trace or assign costs on a cause and effect basis (Section 133 below). The Statement further indicates that it is appropriate to allocate in a two-step basis where the cost are identified to segments (like our stores and theaters) and then to each of the segments (individual stores and theaters) with some common denominator on a pro rata basis. Number of employees is specifically mentioned as an option and then a table is attached showing an example where number of employees is utilized for spreading costs amongst segments (Section 134 and 135 below)

133. Sometimes, it might not be economically feasible to directly trace or assign costs on a cause-and-effect basis. These may include general management and support costs, depreciation, rent, maintenance, security, and utilities associated with facilities that are commonly used by various segments.

134. These supporting costs can be allocated to segments and outputs on a prorated basis. The cost allocations may involve two steps. The first step allocates the costs of support services to segments, and the second step allocates those costs to the outputs of each segment. The cost allocations are usually based on a relevant common denominator such as the number of employees, square footage of office space, or the amount of direct costs incurred in segments.

135. Suppose the total cost of a personnel department for a fiscal year is $500,000, and it is allocated to two segments based on the number of employees of the two segments: segment A has 300 employees, and segment B has 200 employees. On the prorated basis, segment A should be allocated 60 percent, or $300,000 of the personnel cost, and segment B should be allocated 40 percent, or $200,000 of the personnel department cost. The allocation is shown below:

Table 3: The Allocation of the Personnel Dept. Costs

<table>
<thead>
<tr>
<th>Segment</th>
<th>Employees</th>
<th>Percent</th>
<th>Allocated amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>300</td>
<td>60</td>
<td>$300,000</td>
</tr>
<tr>
<td>B</td>
<td>200</td>
<td>40</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>500</td>
<td>100</td>
<td>$500,000</td>
</tr>
</tbody>
</table>
Additionally, Section 146 reinforces the CFO's long standing requirement in SE and SI that although improvement or more accurate methodology is welcomed, it must be documented and explained.

146. The standard requires that a costing methodology, once adopted, be used consistently. Consistent use provides cost information that can be compared from year to year. However, this requirement does not preclude necessary improvements and refinements to the system or methodology, so long as the effect of any change is documented and explained. On the contrary, improvements are encouraged.

Although we welcome any recommendation for improvement, our view is that SE's allocation methodology is appropriate and fair, even as defined in this Federal Accounting Standard which essentially describes SE's method in the example within the Statement. FTE-based allocation systems are common and in use in many large organizations and additionally we identified a large federal agency using the FTE methodology.
APPENDIX C. CONTRIBUTORS TO THE REPORT

The following individuals from the Smithsonian Office of the Inspector General contributed to this report:

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