MINUTES OF THE JANUARY 27, 2009, AUDIT AND REVIEW COMMITTEE MEETING

On January 27, 2009, the Regents' Audit and Review Committee ("the Committee") met at 9:30 a.m. in the Regents' Room of the Smithsonian Castle. Committee Chair John McCarter and member Robert Kogod attended in person; Congressman Sam Johnson and Shirley Ann Jackson participated by teleconference. David Heil, Assistant to Congressman Sam Johnson, was present via teleconference. Staff present at the meeting were Secretary G. Wayne Clough; Under Secretary for Finance and Administration Alison McNally; Chief Financial Officer (CFO) Alice Maroni; Treasurer Sudeep Anand; Executive Assistant to the Secretary Patricia Bartlett; Associate General Counsel Lauryn Guttenplan; Office of the Regents Program Officer Grace Jaeger; Under Secretary for History, Art and Culture Richard Kurin; Chief of Staff to the Board of Regents John Lapiana; Office of the Comptroller, Financial Policies and Procedures Manager Salim Mawani; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; Acting General Counsel Marsha Shaines; Deputy Comptroller Stella Whitsell; and Comptroller Andy Zino. Also in attendance were Herb Schulken, Advisor to the Committee; John Keenan and Rebecca Horton, who represented the Institution's auditors, KPMG LLP; and Jay Ahuja of Booz Allen Hamilton. Minutes were taken by Susan Block, Special Assistant to the CFO.

Committee Chair John McCarter opened the meeting. The Chair announced that the meeting would begin by holding an Executive Session with the Committee members; the Secretary; the Under Secretary for Finance and Administration; the CFO; the Chief of Staff to the Board of Regents; the Inspector General; the Acting General Counsel; the Deputy Comptroller; the Comptroller; the Director of External Affairs (who attended only this portion of the meeting); the Advisor to the Committee; and the Institution's auditors to discuss an issue related to the financial statement audits.

The meeting reconvened at 10:05 a.m.

Approval of the Minutes

A motion was made and seconded and the minutes of the November 17, 2008, meeting were approved.

Review of the Fiscal Year 2008 Draft Financial Statements

Comptroller Andy Zino briefed the Committee on the Smithsonian's fiscal year 2008 draft financial statements. He reported that the Smithsonian ended fiscal year 2008 with $347.0 million in cash and balances with the U.S. Treasury. This $83.6 million decrease from fiscal year 2007 reflected lower returns on short-term investments and greater investments in net trust, Federal property, and equipment during the year. Receivables and advances were also down $26.1 million due to reductions on pledge receivables, trade receivables, and charitable trust receivables (offset by increases in grant and contracts receivables of $15 million).

Total liabilities increased by $66.9 million, due primarily to a rise in unexpended Federal appropriations; an increase in accounts payable and accrued expense balances; and an increase in deferred revenues that were largely attributed to grant and contract activity. These increases were partially offset by the continued recognition of the deferred gain on the sale of the Victor Building and the payments made on long-term debt during the year.

The Smithsonian's total net assets decreased by $100.4 million in fiscal year 2008. The major drop was caused by the unprecedented economic turmoil in the investment markets at the close of the year, which resulted in approximately $199.4 million in total non-operating investment losses. This was offset by a positive result from operations of $104.8 million. Unrestricted and temporarily restricted net assets also reflected investment losses, decreasing $43.1 million and $81.7 million, respectively. Permanently restricted net assets increased $24.4 million, primarily the result of new contributions of approximately $27.3 million for program support during the year. This increase, however, was offset by investment losses of approximately $3.8 million.

Total operating revenues in fiscal year 2008 decreased slightly compared to fiscal year 2007. Government revenues increased by $35.3 million due primarily to the increased revenue recognition for Federal appropriations, as well as government grant and contract revenues. These increases were principally offset by reduced contributions and a reduction in business activities and other revenues.

Total expenses remained basically flat in fiscal year 2008 (less than 1 percent increase) versus fiscal year 2007. Changes within these expenses were highlighted by reduced business activities expenses and reduced administrative expenses, which were principally offset by increases in research expenses, and education, public programs, and exhibitions expenses.

The principal non-operating item for fiscal year 2008 was the $199.4 million investment income loss for the year, down from a $120 million gain from fiscal year 2007. Minor other non-operating variances from fiscal year 2007 amounts were also evident in fiscal year 2008.

Operating activities provided cash revenues of $120.6 million in fiscal year 2008, versus $71.1 million in fiscal year 2007. The level of cash from operating activities is affected by operating results and the timing of receipt of revenues, particularly contributions, and payment of expenses.

Cash used by investing activities was $341.8 million in fiscal year 2008, as compared to $157.3 million in fiscal year 2007. The increase in cash used by investing activities in fiscal year 2008 was due primarily to a decrease in the proceeds from the sale/maturity of investment securities, which was partly offset by a decrease in the purchase of investment securities.

Cash provided by financing activities was $137.6 million in fiscal year 2008 versus $141.0 million in fiscal year 2007. The net decrease in cash from financing activities in fiscal year 2008 was due primarily to a decrease in contributions for construction of facilities that was partly offset by an increase in appropriations for repairs, restoration, and construction.

There were some significant additions to the notes to the financial statements in fiscal year 2008. Four items of significance follow:

- Note 2 (r) — **Summary of Significant Accounting Policies** — provides information on recently issued accounting pronouncements and their applicability to the Smithsonian. Specifically, Financial Accounting Standards Board (FASB) Statement No. 157: Fair Value Measurements, which will be effective for the Smithsonian in fiscal year 2009, and FASB 117-1: Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act [UPMIFA], and Enhanced Disclosures for All Endowment Funds, which provides guidance on classifying the net assets associated with donor-restricted endowment funds held by organizations that are subject to UPMIFA. Smithsonian's Office of General Counsel has determined that the Institution is not subject to this new law but may choose to implement the standards in a future period.

- Note 11 — **Net Assets** — is a new footnote that discloses the purpose behind the Institution's temporarily restricted net assets, as well as the nature of the assets released from restriction during the year. It also discloses the composition of the restrictions on the use of income derived from permanently restricted net assets.

- Note 13 — **Income Taxes** — includes new disclosures related to FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes.

- Note 15 — **Subsequent Events** — includes an update on the condition of the Institution's investment portfolio due to the continuing upheaval in the investment markets.

Status Report by KPMG on the Fiscal Year 2008 Financial Statements

KPMG Senior Partner John Keenan informed the Committee that the audit of the "closing package" special-purpose financial statements for Federal Funds was completed in accordance with Department of Treasury and Office of Management and Budget (OMB) requirements in November 2008. He stated that an unqualified opinion had been issued on the 2008 and 2007 special-purpose financial statements. He told the Committee that the audit of Smithsonian-wide financial statements was being performed pursuant to the plan presented at the Committee's meeting in September 2008, as it was focusing time and attention on nonroutine transanctions; key accounting estimates; and financial reporting and disclosure. He stated that he believed the audit of the Smithsonian-wide financial statements would be completed by the January 30, 2009, deadline. He reported that an audit of Smithsonian Enterprises (SE) special-purpose financial statements for 2008 should be completed by the February 6, 2009, deadline. He reminded the Committee that the SE audit was being performed to satisfy an Office of the Inspector General (OIG) request for additional assurance on SE's "net gain."

Mr. Keenan stated that the audit of the Smithsonian-wide financial statements was proceeding well and that KPMG had noted substantial progress in the Smithsonian's closing and financial reporting process. He noted that, in comparison to recent years, there had been significant decreases in the number of audit adjustments required and in the number of uncorrected audit differences.

Mr. Keenan reminded the Committee that KPMG had identified seven significant deficiencies in internal controls in 2007. He reported that the Smithsonian had made substantial progress in addressing the related recommendations and stated that the steps the Institution had taken to correct the deficiencies have been substantive in nature, not just "band-aid fixes." He also reported that KPMG had noted a small number of control deficiencies in 2008 but would not be in a position to make its final assessment of them until the audit was completed.

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

Mr. Keenan informed the Committee that the management letter should be ready in mid-February 2009. The Chair asked the CFO to schedule a meeting of the Committee in February 2009 to discuss the management letter.

Review of Plan to Strengthen Internal Controls: Governance Reform #23

CFO Maroni stated that, pursuant to Governance Reform Recommendation #23, a major review of the Smithsonian Institution's financial reporting systems and internal controls had been conducted over the last 18 months. She reminded the Committee that with the assistance of Booz Allen Hamilton, Team #23 identified and evaluated a universe of 23 critical financial and complementary processes. This universe of processes was mapped against the Institution's financial statement to ensure that the most critical processes were included for review. The "As Is" and "To Be" internal control environments were assessed for each process. After identifying the control gaps, all 23 processes were ranked in terms of their significance to the Institution's mission, their importance to an accurate financial reporting process, and their potential risk to the Institution should the controls fail to be strengthened. In all cases, the rationale for the risk rating was agreed to by each process owner.

Customized implementation plans then were developed in tandem with the process owner. The plan was informed by the resource priorities identified by the process owner and reflects the CFO's judgment about what constitutes a reasonable, yet responsible pace for the plan's implementation. The plan provides a roadmap for improving the Institution's overall internal controls environment. For the first time, the Institution has a comprehensive view of its internal control deficiencies, the actions required to address the problem areas, and a preliminary estimate of the remediation costs.

The implementation plan began in fiscal year 2009 and will extend to fiscal year 2015. It includes an estimate of the funding required to establish a regime of adequate internal controls, which will be identified by low-risk priority scores. It was noted that there is one caveat to the implementation plan, which is that the processes associated with the recording and managing of charitable gifts to the Institution pose a very specific problem for this analysis. In light of the lack of systems and process integration, that process owner has established that a major process redesign will be necessary before progress milestones and costs can be reasonably estimated. Consequently, the implementation plan makes no assumptions about how quickly adequate internal controls will be implemented or the nature of the resources that will be required to achieve a low-risk status for the Charitable Contributions process. Nevertheless, the required actions identified by that process owner were recorded as part of this analysis. With the required funding phased and assuming that the funds are provided according to the timeline established in the plan, all of the remaining processes identified should achieve moderate- or low-risk priority scores by fiscal year 2014. More importantly, they should all achieve low-risk priority scores by fiscal year 2015.

The proposed actions necessary to mitigate internal control gaps were categorized for the purpose of analyzing the nature of the gap confronting the Institution. The analysis identified a total of 256 required actions. Forty-eight percent were deemed to be priority actions, or specific actions on which measureable improvements in the control environment depend, and a third of all the required actions pertain to the development, documentation, and dissemination of policies and procedures.

The CFO noted that effective execution of this plan will require a commitment to increasing staffing and other resources over time. Recognizing that the activities that support internal controls are staff- and technology-intensive, the plan for additional funding supports a phased implementation strategy. The estimated cost for the plan is $14.6 million in constant fiscal year 2009 dollars, unadjusted for inflation. Fifty-four percent of the total cost is for 64 additional dedicated staff required to perform internal control functions. Notably, the cost estimate does not include the costs of: redesigning the Charitable Gift process or implementing the systems changes that a redesign will entail; information technology and systems support where process owners have not done the analysis required to identify requirements and cost estimates are unavailable; or the additional office space that will be required for the new staff resources.

With respect to staff increases, it was noted that the Institution is positioned to provide an increase of 14 Federal positions through fiscal year 2010 and that, through fiscal year 2009, the Institution is positioned to provide an increase of two Trust positions. Taken together, these 16 positions represent 25 percent of the total increase outlined in the plan for strengthening internal controls.

The CFO recommended that primary focus be given to the five high-risk areas with attention paid selectively to other critical medium-risk areas. The predominant element shared by the five processes is the need to develop, document, or update existing policies and procedures.

The Chair commended the CFO on an excellent report and asked Mr. Ahuja to comment on it. Mr. Ahuja stated that the process was a top-down process and that he was impressed by the cooperation and engagement of the process owners. Mr. Schulken also commended the work on the report and stated that it was his experience that when private companies do this exercise they throw thousands of people at the problem; he added that he found it remarkable that Smithsonian staff had this performed this assessment in concert with fulfilling their other full-time professional responsibilities. Mr. Kogod likewise commended the efforts but noted that he thought the timeline to complete the process extended too far into the future. He stated that he did not think the Regents were going to be comfortable with a fiscal year 2014 completion date for all areas to achieve a moderate risk status. He also said that he realized that budget restraints have to be taken into consideration.

There was considerable discussion regarding the best way to address the Smithsonian's internal control problems using limited available resources while also balancing the other priorities of the Institution, such as collections care and research. Secretary Clough stated that he had asked his senior management team to take another look at the problem and see if it would be feasible to hire a contractor to do some of the work. It was decided that the top priority would be to address the high-risk areas with the Under Secretary for Finance and Administration taking the lead.

The Chair stated that he will have to report back to the Regents at their April 2009 meeting and that the Regents will not be satisfied with a fiscal year 2014 completion date. He tasked the CFO to come back to the Committee at its March 2009 meeting with an expedited implementation plan.

The Inspector General stated "in defense of rules and bureaucracy" that there is always a tension between programs and process. She emphasized that properly correcting internal controls was very important and that doing so increases efficiency, produces economies for the core program, and reduces the risk of loss of money and reputation.

The Under Secretary for History, Art and Culture stated that, while he agreed internal controls are important and egregious deficiencies should be corrected, a status of perfection should not be pursued at the expense of other institutional priorities that are also at high risk of failure.

Inspector General Update

Inspector General Sprightley Ryan informed the Committee that her office had issued the Travel Audit on January 23, 2009. She told them that there was nothing in the audit that she hadn't discussed previously with the Committee and that in fact there had been positive findings, such as several instances of senior executives saving the Institution money while on travel.

She reminded the Committee that her office underwent a peer review in December 2008, which was conducted by the Inspector General of the Federal Reserve Board. She reported that her office received a clean opinion with three findings, and she informed the Committee that the opinion will be posted on the OIG website. She informed the

Committee of the results of a recently concluded worker's compensation case and a case concerning the theft of books at the National Museum of Natural History by an individual then-employed as a temporary fellow. Unfortunately the extent of that loss is unknown as there is no accurate inventory in that library or other internal controls over its materials; in addition, the individual was fired before the OIG was made aware of the theft. She said that as a result of that incident her office is working with Office of Protection Services (OPS) on the procedures for securing a crime scene. She said that her office is also working with the National Museum of American History and the National Museum of Natural History to assess and reassess their high-risk areas.

Ms. Ryan stated that improvements to the OIG Web site are being made that will make automatic notifications of new Web site postings. She stated that her office will also be completing a quality assessment of KPMG's conduct of the fiscal year 2008 financial statement audit, including the first-time review of Smithsonian Enterprises' statement of net gain. She noted that her office had nearly concluded a discussion draft on privacy related to information technology. She also stated that she had met with the Office of Contracting and Personal Property Management on the new Federal Acquisition Regulation rules concerning contracts over $5 million where contractors must self-report any accusations of fraudulent activity; she said that the Smithsonian will address this issue by inserting a clause into all contracts. She also reported that the worker's compensation audit would be completed in early February.

Ms. Ryan then submitted a proposed resolution for Committee's consideration regarding former National Museum of the American Indian Director W. Richard West. The resolution stated:

> **RESOLVED**, that in light of the report of the Inspector General on the travel and expenses of W. Richard West, former director of the National Museum of the American Indian, the Committee expresses its dismay at Mr. West's decision to accept and retain an honorarium of $27,776, while spending one month away from the museum in the fall of 2006 co-teaching a course on Indian law at the University of Oregon Law School even though this activity was not clearly prohibited by Smithsonian policies at the time, and encourages Mr. West to consider returning the honorarium to the National Museum of the American Indian.

The Inspector General stated that, consistent with her advice to the Committee Chair, she was proposing that the Secretary telephone Mr. West and discuss the resolution. The Secretary stated that, since he did not know Mr. West, it would make more sense for the Under Secretary for History, Art and Culture to make the call. While not taking formal action on the draft resolution, the Committee agreed, and the Under Secretary for History, Art and Culture agreed to contact Mr. West.

The meeting adjourned at 11:30 a.m. The Committee then conducted three separate executive sessions with the IG, CFO, and the Acting General Counsel, after which it met alone.