MINUTES OF THE MARCH 30, 2009, AUDIT AND REVIEW COMMITTEE MEETING

On March 30, 2009, the Regents' Audit and Review Committee ("the Committee") met at 9:30 a.m. in the Regents' Room of the Smithsonian Castle. Participating were Committee Chair John McCarter and members Shirley Ann Jackson*, Congressman Sam Johnson, and Robert Kogod. Also participating were Assistant to Congressman Johnson David Heil and Committee Advisor Herb Schulken*. Participating staff included Secretary G. Wayne Clough; Treasurer Sudeep Anand; Chief of Staff to the Secretary Patricia Bartlett; Director of External Affairs Virginia Clark; Director of the Office of Planning, Management and Budget Bruce Dauer; Assistant Inspector General for Audits Daniel Devlin; Office of Development, Development Services Director Zully Dorr; Office of Contracting and Personal Property Management Director Robert Fraga; Office of the Regents Program Officer Grace Jaeger; Chief of Staff to the Board of Regents John K. Lapiana; CFO Alice Maroni; Office of the Comptroller, Financial Policies and Procedures Manager Salim Mawani; Under Secretary for Finance and Administration Alison McNally; Associate General Counsel Christine Nicholson; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; Chief Information Officer Ann Speyer; Deputy Comptroller Stella Whitsell; and Comptroller Andy Zino. Also in attendance were Ellen Harrison and Rebecca Horton, who represented the Institution's auditors, KPMG LLP. Minutes were taken by Susan Block, Special Assistant to the CFO.

Committee Chair John McCarter opened the meeting. The Chair asked that the January 27, 2009, minutes be amended to show that member Shirley Ann Jackson participated by teleconference. The minutes were approved subject to that correction.

Review of Cancelling Federal Balances

The Committee discussed at length the arcane but important Federal process of cancelling funds. Raised at the Committee's March 6, 2009, meeting by Congressman Sam Johnson, the issue concerns the expiration for obligation after one year of unspent Salaries and Expenses (S&E) funding appropriated by Congress, and the subsequent return to the U.S. Treasury, five year later, of funds that remain unspent. Office of Planning, Management and Budget Director Bruce Dauer briefed the Committee on how the process worked and management's efforts to limit the balances that cancel. The Committee expressed concern about the magnitude of the fiscal year 2008 funds that cancelled and reverted to the Treasury — $4.2 million or 0.9 percent of the fiscal year 2003 S&E appropriation.

Mr. Dauer outlined the highly disciplined process that Congress established to limit the availability of Federal funds after they have been appropriated to prevent agencies from using old appropriations for unapproved purposes. He noted that, as a consequence of concerted efforts to avoid overspending, every well-run agency has some funds that properly revert to the Treasury when they cancel and that the Smithsonian's cancelling

** participated by teleconference*

balances were in line with other agencies. All agencies, including the Smithsonian, were noted as conservative in managing their expiring and cancelling balances because, depending on the circumstances, there could be criminal penalties for overspending Federal appropriations. Mr. Dauer said that the issue for management was to make the amount that cancels at the end of five years as small as possible without overspending. He also said that management had a limited number of tools available to influence the size of the amount that cancels, and that those tools could only be employed during the first year an appropriation is available for obligation, after which there were five years of activity over which management had very little control.

Mr. Dauer outlined the progress the Institution had made in recent years to reduce the size of the expiring balance of unobligated funds. Mr. Dauer explained that following expiration, funds (during years two to six) could only be used to make upward adjustments in previously under-recorded obligations or to record legitimate unrecorded obligations incurred during the first year of an appropriation. All adjustments to expired balances are mechanical, the sum of which are reflected in the cancelling balance five years after the funds expire (at the end of year one). Mr. Dauer provided the following examples of why the unexpended balance of funds routinely grows in expired status (during years two to six): the completion of a contract or purchase order task at less cost than estimated; the reversal of an accrual at year-end for an expense that was lower than estimated (for example, for travel); the failure of a contractor to bill for the full amount of services provided; the departure of a provider from the marketplace, leaving contracts or purchase orders unfulfilled; and a delivery delay, which can lead to erroneous charges against current rather than expired funds.

Mr. Dauer noted that the natural tendency was to obligate enough on every contract or purchase order to ensure the work was completed without having to add current year funds when the bill comes due. The Inspector General asked what percentage of the growth in the unexpended balance was due to unbilled or unfulfilled contracts or purchase orders versus an inability to properly estimate the amount needed. Although her question could not be answered, the Comptroller noted that, if every procurement official added a small amount to each procurement to avoid overspending and to ensure work was accomplished, the unspent amount would add up to millions of dollars, given the number of procurements.

Mr. Dauer noted that a comparison of cancelling balances at the Smithsonian, the National Gallery of Art, the Office of Management and Budget (OMB), and the National Science Foundation showed that the Smithsonian's cancelled balances were in line with the experience of other like-sized organizations. In response to a question, Mr. Dauer noted that this was a uniquely Federal issue and that the Institution's Trust budget did not have a similar problem. He told the Committee that the Defense Department had special authority to allow expired funds in years four and five to be transferred to active accounts to offset fluctuations in foreign currencies, thereby limiting the amount that cancelled and reverted to the Treasury.

Mr. Dauer indicated that his office planned to issue a memo shortly to the units that were the worst offenders with regard to unexpended obligations. The purpose of the memo was to remind them of the importance of managing unexpended obligations and monitoring obligations on open contracts and purchase orders. In response to a request from the Chair, Mr. Dauer agreed to provide a copy of the memo to the Committee.

Dave Heil informed the Committee that he had had discussions with Senator Cochran's office on proposing legislation that would allow the Smithsonian to repurpose expired funds prior to cancellation, but said that he had been told that approval of such a proposal would be unlikely. He stated, however, that such legislation will be proposed.

Update on Governance Reform #23 – Internal Controls

CFO Alice Maroni briefed the Committee on management's plan to strengthen internal controls. She reminded the Committee that management reviewed 23 separate financial processes and that, while 18 were identified as moderate or low risk, five were identified as high-risk areas. She also reminded the Committee that they had challenged her at their January 2009 meeting to accelerate the timeline for addressing these areas and to reduce the costs of the proposed remediation plan. She reported that the timeline associated with the plan had been accelerated, new staff requirements had been reduced, and estimated implementation costs also had been reduced.

The Secretary told the Committee that he had instructed the Under Secretary for Finance and Administration to work with the CFO to take another look at the best way to accelerate the plan. The Under Secretary for Finance and Administration informed the Committee that she and the CFO worked with each of the high-risk area process owners and with the other Under Secretaries to revise the plan and garner their support. The Secretary stated that he had challenged the Under Secretaries to commit to this plan. He told the Committee that part of the current problem was that many of the Institution's processes were not automated.

With respect to one of the high risk areas — charitable contributions — it was reported that the Office of External Affairs had hired a consultant to advise them on the systems and business process improvements required for a successful campaign. The consultant's final report will be due late summer 2009. Director of External Affairs Virginia Clark told the Committee that this was the Development Office's number one priority and that her office had already started to implement some key internal control improvements prior to receiving the consultant's report.

The CFO told the Committee that, with respect to personal property management, the heart of the control recommendation plan was the use of dedicated accountable property officers (APOs) to provide uniform management and processing of personal property assets, thereby improving internal controls and financial reporting. She told the Committee that dedicated APOs would be detailed to the units at highest risk for property loss, based on the historical record and the quantity of personal property assets owned (namely, the Museum of Natural History, the Office of Facilities Engineering and Operations, and the Office of the Chief Information Officer). It was reported that three new APO positions had been approved for inclusion in the Institution's fiscal year 2010 Federal budget request. The CFO told the Committee that the revised timeline for the controls remediation plan included two fewer FTEs than noted in the original plan. She said that this change reflected a year-over-year budget reduction of $334,000 through fiscal year 2011 from the remediation budget originally proposed. She told the Committee that a future phase of the project would include another review of the proposed pace and cost of improving the moderate risk areas.

Update on IRS Form 990 for Fiscal Year 2008

Comptroller Andrew Zino informed the Committee that the fiscal year 2008 IRS Forms 990 and 990-T were being prepared and that this would be the final time that the old version of the 990 would be used. He told the Committee that the Institution had received a filing extension and anticipated obtaining an additional extension to August 15, 2009. The Comptroller requested guidance from the Committee on the role that the members would like to play in the filing of the fiscal year 2008 return. After being informed by Mr. Zino that the review process for the return included extensive review by the Comptroller, the General Counsel, outside counsel engaged by the Institution, and the Institution's external auditor KPMG LLP, the Committee agreed that there was no need for it to conduct a special session to review the fiscal year 2008 filing. The Committee agreed to conduct a formal review of the fiscal year 2009 filing when the new instructions go into effect.

The Comptroller notified the Committee that the Institution's use of alternative investment strategies had complicated the preparation of the Form 990-T this year. He requested, and the Committee approved, the engagement of KPMG LLP for non-audit assistance on the preparation of this important tax document. He told the Committee that he anticipated that KPMG would only require a few hours to review the K-1 schedules and provide the necessary advice.

Update on the Compliance Review Plan

The Committee was reminded that the Office of the Comptroller performs policy compliance reviews annually and keeps the Committee abreast of the annual compliance review plan. In keeping with past practice, the Comptroller reviewed the plan for the next 12 months. With respect to fiscal year 2008, he stated that his office complete 9 of the 14 reviews scheduled. He noted that staff time has been unavoidably diverted to unplanned compliance reviews and higher priority initiatives that are largely governance-related.

Inspector General Update

Inspector General Sprightley Ryan introduced new Assistant Inspector General for Audits Dan Devlin to the Committee.

Ms. Ryan informed the Committee that she was pleased to announce the completion of her office's audit of the Institution's worker's compensation program. She noted that after the audit's recommendations were implemented the Institution would require fewer appropriations for this program in the future. She also commended the Office of the

Comptroller for recently closing three open audit recommendations that had been open for longer than three years. She informed the Committee that several open audit recommendations related to the OIG travel audit had been closed and complimented the CFO's office for the new edition of the Travel Handbook that had been recently reissued, noting that the Institution had addressed its travel policy issues. She also reported that her office recently completed the overall Federal Information Security Management Act (FISMA) for fiscal year 2008. Additionally, she said that her office recently conducted a number of after-hour "walk-throughs" of offices to look for inappropriately displayed and/or accessible personal or otherwise sensitive information. This effort followed a previous after-hours tour and the issuance of a management advisory letter that identified many security problems. She was pleased to report that her team found significant improvements on its latest tour.

Ms. Ryan noted that OMB expects Inspectors General to be involved in the oversight of funds received from the American Recovery and Reinvestment Act and that her office would be performing that function. Additionally, she said that her office had begun or would shortly begin audits or reviews of collections security and inventory controls at the National Air and Space Museum; of the implementation of the Showtime contract; of personal property management; and of capital projects. She noted that she would be testifying before the House Appropriations Committee on May 13, 2009, along with the Government Accountability Office. It was noted that the Secretary also was scheduled to appear on the hearing's second panel.

The Secretary and the Under Secretary for Finance and Administration also updated the Committee on management's efforts to improve the administration of Smithsonian-related travel. The Committee was advised that the Under Secretary for Finance and Administration had convened a task force at the Secretary's behest to assess the administration of Smithsonian-related travel and to suggest ways to make the process easier. In addition, the Under Secretary for Finance and Administration and the CFO hosted a three-day summit using a facilitator to review the total travel administration process. This examination revealed that the biggest complaint was not with the travel policy or the core automated authorization and vouchering system, but rather with the booking agent employed by the Institution. Following that meeting, the CFO engaged an alternative booking agent to facilitate Smithsonian travel and much of the criticism of travel administration was alleviated. The Under Secretary stated that the Travel Advisory Group, a pan-Institutional group dedicated to maintaining open communication on travel issues, would continue to meet monthly.

The meeting adjourned at 10:50 a.m. The Committee then conducted an executive session with the IG, after which it met alone in executive session.