# MINUTES OF THE SEPTEMBER 8, 2009, AUDIT AND REVIEW COMMITTEE MEETING

On September 8, 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**, 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; Assistant Inspector General for Audits Daniel Devlin; Deputy Director/Chief of Staff, Office of Facilities Engineering and Operations, Clair Gill; Chief of Staff to the Board of Regents John Lapiana; General Counsel Judith Leonard; Chief Financial Officer (CFO) Alice Maroni; 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, Rebecca Horton, and John Keenan, who represented the Institution's auditors, KPMG LLP. Minutes were taken by Susan Block, Special Assistant to the CFO.

Member Robert Kogod called the meeting to order at 9:45 a.m.

### Approval of the Minutes

A motion was made and seconded and the minutes of the March 6 and March 30, 2009, meetings were approved.

### KPMG Fiscal Year 2009 Audit Plan and Fiscal Year 2008 A-133 Audit Results

KPMG LLP Senior Partner John Keenan presented the highlights of the fiscal year 2009 audit plan and noted that planning and interim work was complete. Mr. Keenan told the Committee that the core KPMG audit team was unchanged from the prior year with the exception of two specialists, Financial Risk Management Specialist Nick Katsanos and Information Risk Management Senior Manager Andrew Littekan. He reminded the Committee that KPMG would provide reports on the results of the audited financial statements, as well as several other special purpose reports. He then introduced Rebecca Horton, who discussed the audit process.

Ms. Horton informed the Committee that the objective of an audit of financial statements is to enable an auditor to express an opinion about whether an organization's financial statements have been prepared, in all material respects, in accordance with generally accepted accounting principles (GAAP). She noted that the process was designed to provide reasonable, but not absolute, assurance that the financial statements taken as a whole are free from material misstatement. She discussed the responsibilities of both KPMG and management in the performance of the audit. She told the Committee that professional judgment is used to determine audit risk and materiality both in planning the audit and designing audit procedures, as well as to evaluate the effects of misstatements. She noted that materiality considerations are both quantitative and qualitative and that materiality is determined separately for each audit included in the scope of work.

** participated by teleconference*
*** joined meeting in progress at 10:05 a.m.*

Ms. Horton then discussed the three areas that would be emphasized in the fiscal year 2009 audit: recurring transactions, nonroutine transactions, and key accounting estimates and "other." She noted that recurring transactions, such as cash disbursements and payroll, contributions, investment purchases and sales, satisfying donor restrictions, accounting for construction activities, and debt financing and compliance with related debt covenants, are usually high volume and routine in nature. She stated that these areas demand that KPMG understands which controls are in place and is able to test those controls. With regard to nonroutine transactions, she told the Committee that the Smithsonian would adopt two new accounting standards in the fiscal year 2009 audit: FSP 117-1, which will require new disclosures on the Endowment, and the Statement of Financial Accounting Standards (SFAS) 157, which will redefine how fair value is measured. Regarding key accounting estimates and "other," Ms. Horton said that KPMG would review how management developed these estimates and evaluate whether the underlying assumptions and judgments were reasonable and adequately supported. She informed the Committee that the same three areas would also be emphasized on the audit of Smithsonian Enterprises (SE). She said that the audit of SE's recurring transactions would include cash disbursements and payroll, magazine circulation, museum shop sales and mail order fulfillment, purchases and inventory management, concessions and theater cash receipts, and license agreement billings and cash receipts. With regard to SE's nonroutine transactions, she noted that the reorganization of the unit's business activities would be reviewed. She said that KPMG would review a number of areas, such as the evaluation of inventories and provisions for sales returns, to address key accounting estimates and "other."

Ms. Harrison next discussed SFAS No. 157 and informed the Committee that this standard redefines how the fair value of investments is determined and requires increased disclosures on fair value measurements. She discussed the hierarchy of fair value measures prescribed by SFAS No. 157 and its particular emphasis on the potential impact on nonmarketable investments. For these investments, she noted that there also was a proposed standard that would allow the Smithsonian to use the net asset value reported by its investment managers as an estimate of fair value. Ms. Harrison told the Committee that planning meetings for the initial adoption of SFAS No. 157 were held with the Office of Investments and the Office of the Comptroller in June and August 2009 and that another progress meeting was scheduled for October 2009.

Ms. Harrison then discussed the audit of fraud risk. She explained that KPMG would look for incentives or pressures that could lead to an increased risk for fraud and that, as part of this review, KPMG would meet with various members of management, the Committee, and the Office of the Inspector General (OIG) to identify and discuss any concerns about this area. Ms. Harrison said that this audit would require close coordination between KPMG and the OIG as the contracting officer's technical representative. She said that there would be regular communication with the OIG staff, including weekly status meetings during audit fieldwork. She stated that KPMG also would review selected reports issued by OIG to ensure that KPMG is aware of any indications of control weaknesses.

The audit timetable was then discussed. Ms. Harrison said that KPMG would start fieldwork on the audit of the Federal closing package financial statement in October 2009 and that the Federal closing package would be submitted by November 16, 2009. She stated that final fieldwork on the audits of the Institution's comprehensive financial statements and SE's statement of net gain would begin after the closing package was submitted. She also noted that planning for the A-133 audit would begin during December 2009–January 2010 and that most of the audit procedures would be completed by the end of March 2010. She said that the June 2010 release of the A-133 audit was planned to coincide with the Defense Contract Audit Agency's (DCAA) anticipated completion of its portion of the audit. She reminded the Committee that KPMG would again comply with Statement on Auditing Standards No. 114, which addresses communications with the Committee about the audit process and results, and with Statement on Auditing Standards No. 115, which concerns management letter recommendations and notations of significant deficiencies and material weaknesses (if any).

Ms. Harrison then discussed the results of the 2008 A-133 audit of Federal expenditures. She said it was determined that the criteria that apply under A-133 were used by three major Smithsonian program areas: research and development (R&D), the partnership between the United States Postal Service and the National Postal Museum, and the involvement of the Department of Commerce in the *Oceans* exhibition. She said that KPMG tested the controls for the three programs and reviewed the compliance of the programs with OMB rules and provisions for grants and contracts. The R&D portion of the audit was coordinated with DCAA and an unqualified audit opinion was issued. The audit on the National Postal Museum was performed by KPMG and an unqualified opinion was issued. Ms. Harrison said that the *Oceans* exhibit elicited an unqualified opinion on compliance but that there was a finding related to the application of the indirect cost rates. Comptroller Andy Zino informed the Committee that the Institution renegotiated the terms and conditions of that particular grant with its sponsor, allowing the Institution to recover its costs and not incur a loss. He said that the issue was resolved to the satisfaction of KPMG.

Advisor Herb Schulken asked KPMG about two issues: the decision to add Nick Katsanos to the audit team and how KPMG's audit approach had changed in response to the markets' turmoil over the last year. Ms. Harrison explained that Mr. Katsanos replaced Troy Tonnessen, who relocated and was promoted to partner. She noted that Mr. Katsanos's background includes hedge fund management and that he is very astute at reviewing investments. Mr. Schulken asked if there were any other changes in the auditing approach and Mr. Keenan responded that the timing of the SE audit had been modified. He explained that the SE audit began earlier than the fiscal year 2008 SE audit to allow time for more robust interim procedures. With regard to actual strategy and key procedures, Mr. Keenan stated there were no significant changes. Comptroller Zino told the Committee that, in accordance with its direction, his office had accomplished more work during the interim period. He reported, and Mr. Keenan confirmed, that significant information on fixed assets, Federal reporting, and contribution activities had been furnished to KPMG during its interim testing period. The Comptroller added that his office would continue to provide as much audit information as possible to KPMG during future interim testing periods.

## Inspector General's Update

Inspector General (IG) Sprightley Ryan discussed various reports issued by her office, as well as reports that were in progress. She told the Committee that her office had issued three reports a few months prior to this meeting. One report on IT security confirmed the

Institution's compliance with its security policies. A second report addressed the Institution's privacy program. She explained that the scope of the second IT security review was broader than the first and that the final report recommended that the Institution develop a full-fledged privacy program, develop appropriate privacy policies, reduce the use of personally identifiable information, and increase the security that guards such information. She informed the Committee that management agreed with the recommendations and would be implementing necessary corrections. The third report, which was done by an outside firm, was a review of the non-travel expenses of Smithsonian executives and boards. Although the outside auditors questioned about 10 percent of the costs they reviewed, Ms. Ryan said that her office found very few problems and that her office would not conduct similar reviews in the immediate future.

Ms. Ryan then reported that, at the request of Chairman Robert Brady of the Committee on House Administration, her office had conducted a review of the implementation of the Smithsonian Networks contract with Showtime Networks Inc. Chairman Brady had requested a review of how the contract had affected third-party filmmakers, how the Institution documented film requests, and what financial costs had resulted from this contract. She said that her office discovered that the contract had a minimal impact on third-party filmmakers who want to use Smithsonian content in their programs. She stated that her office found that the Smithsonian had improved its decision-making process by implementing a central monitoring and tracking system that includes documentation for each film request decision. She stated that during the period reviewed, the Smithsonian received approximately 446 film requests and declined only two requests based on restrictions in the contract. Further, contract restrictions had not resulted in the decline of any film requests since August 2006. On the financial side, she reported that the sum of the Smithsonian's revenues from this initiative were lower than original projections but that the Institution had received the minimum revenues guaranteed under the terms of the contract. She stated that her office also looked at the project's revenue-sharing plan and its ability to distribute, after covering costs, revenue received from Smithsonian Networks to the Central Trust and to the units. Under the revenue-sharing plan, proceeds from annual licensing and other fees are split evenly between the Central Trust and the units. She stated that adequate procedures are in place to track the costs of administering the contract. She told the Committee that she had sent the report to Chairman Brady and ranking minority member Dan Lungren.

The Inspector General told the Committee that the terms of the American Recovery and Investment Act, also known as the Stimulus Fund, require that IG offices oversee the management of stimulus funding. She informed the Committee that her office was closely tracking the $25 million in stimulus funds received by the Smithsonian and that the Institution was generally doing an excellent job of spending its funds quickly and effectively. She said that more transparency was needed, as all of the award information had not been posted on the Smithsonian's public Web sites. She stated that the contract files also could be better organized. She added that all of the Smithsonian's stimulus funds should be obligated by the end of September 2009.

She next presented the results of an OIG audit that found that the Institution had used Federally appropriated maintenance funds for unplanned capital projects. While management agreed with most of the audit's findings, it disagreed with the finding of misuse of appropriated funds. During the Committee's lengthy discussion, some members expressed concurrence with management's view. Management agreed with substantially all of the recommendations in the report, including the need to develop and communicate a formal policy on the proper use of maintenance and capital funds for unplanned requirements, the need to improve the documentation of funding source decisions and rationale, and the need to train those who authorize the use of Federal funds.

Ms. Ryan then reported on other reports currently under way, including a second maintenance report. She said that preliminary findings indicated that the Smithsonian was spending its money appropriately, that priority plans for maintenance spending were in place, and that no instances of injuries had been caused by disrepair. She said that the audit of Smithsonian Networks' contracts would be done by the end of the fiscal year and that her office also was issuing two draft reports, one on collections security and inventory controls at the National Air and Space Museum and another on Smithsonian-wide personal property and accountability controls.

**Presentation of the Fiscal Year 2010 Audit Plan**

Inspector General Ryan next discussed the fiscal year 2010 audit plan with the Committee, which will include a new audit in the mandatory audit category and the annual audit of travel and other expenses of the Board of Regents, which is required under the Smithsonian's statute. She stated that her office had already begun an audit on collections stewardship at the National Museum of American History.

The Chair asked the Inspector General to focus on the security of the Smithsonian's collections and to reconsider the timing of an audit of the security of the collections of the Smithsonian Institution Libraries, which is on the list of potential audits. He suggested that it might be conducted in the coming year and Ms. Ryan agreed to consider doing so.

**Chief Financial Officer's Update**

CFO Alice Maroni updated the Committee on the activities of the Office of the Chief Financial Officer. She provided a status report on the resolution of issues identified by KPMG in prior years' management letters and indicted that all issues scheduled to be closed during fiscal year 2009 were either on track or already completed.

CFO Maroni informed the Committee that a decision was made to hire a tax accountant in the Office of the Comptroller, which the Committee agreed was a good idea. There was a discussion about the Institution's annual tax filing and more specifically about the unrelated business income tax (UBIT) implications of real estate investments for the Smithsonian. The Committee requested that the CFO and Comptroller prepare an information paper on whether the Smithsonian's alternative investment gains associated with real estate investments would be subject to UBIT.

With regard to internal controls, she informed the Committee that progress had been made on all controls identified for improvement. She informed the Committee that one of the most controversial actions under way was an effort to create a Smithsonian directive about the acceptable use of non-Federal funding. She noted that a draft policy was expected to be released for review in the fall of 2009. She told the Committee that the new directive would formalize a process currently handled by a number of informal policies. With regard to the remaining 18 processes that were under review, she reported that concerns had increased about two areas: financial reporting and data security. With regard to data security, she noted that the raised security standards imposed by the credit card industry had made them difficult to achieve. She said that although the Institution was nearly compliant with the purchase card industry's data standards last year, much more work now has to be done. Consequently, this issue was downgraded from green to yellow.

With respect to financial reporting, CFO Maroni also expressed concern about increasing reporting requirements (e.g., the new Form 990) and the quality of the data being reported. She informed the Committee that senior leadership had responded to this concern by including funding in the Smithsonian's fiscal year 2011 Federal budget request to support staffing increases in this area.

With respect to accountability and compliance, she reminded the Committee that a key priority identified in the Regents' Governance Report was the need to foster a culture of accountability within the Institution. Ms. Maroni reported that efforts to cultivate accountability are ongoing; she added that this commitment is evident in the Institution's Statement of Values and Code of Ethics, addressed in the performance plan of every senior executive, and supported by the draft Strategic Plan's emphasis on integrity.

Dr. Jackson asked whether the Committee was the correct body to review the Institution's tax return or whether this action should be undertaken by the Board of Regents. The CFO responded that the Committee had previously agreed that some or all of the Committee could review the tax return, after which it would be sent to the Board of Regents. She noted, however, that specific details about this process had yet to be worked out.

The meeting adjourned at 11:20 a.m. The Committee then conducted four separate executive sessions with KPMG, the General Counsel, the IG, and the CFO, after which it met alone.