

MINUTES OF THE NOVEMBER 17, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On November 17, 2008, the Regents' Audit and Review Committee ("the Committee") met at 3:55 p.m. in the Executive Conference Room of the National Museum of Natural History. Committee Chair John McCarter and Committee members Congressman Sam Johnson, Robert Kogod, and *ex officio* member Roger Sant attended in person. David Heil, Assistant to Congressman Sam Johnson, participated in person and Committee member Dr. Shirley Ann Jackson participated by telephone. Staff present at the meeting were Secretary G. Wayne Clough; Acting Under Secretary for Finance and Administration Alison McNally; Chief Financial Officer (CFO) Alice Maroni; Associate General Counsel Lauryn Guttenplan; Office of the Regents Program Officer Grace Jaeger; Office of the Comptroller, Financial Policies and Procedures Manager Salim Mawani; Sharon Shepard, Office of the Comptroller; Inspector General (IG) Sprightley Ryan; and Acting General Counsel Marsha Shaines. Also in attendance were Herb Schulken, Advisor to the Committee, and John Keenan, 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.

APPROVAL OF MINUTES

A motion was made and seconded and the minutes of the September 18, 2008, meeting were approved.

KPMG ENGAGEMENT WITH THE SMITHSONIAN TROPICAL RESEARCH INSTITUTE (STRI)

Under its charter, the Committee is required to pre-approve non-audit services provided by the Institution's external auditor. In July 2008, the Committee approved the extension of the engagement of KPMG's Panama City office by STRI to provide advisory services relating to the redesign of STRI's compensation system. CFO Maroni informed the Committee that, pursuant to the Committee charter, Committee Chair John McCarter approved an additional extension in October 2008 for non-audit services in connection with the same STRI project. As with the earlier phase of the project, KPMG has judged that this service will not impair their independence as the Smithsonian's external auditors.

GOVERNANCE REFORM #23: INTERNAL CONTROLS

CFO Maroni discussed the Final Report to the Committee on Regents' Governance Recommendation #23, which was prepared by Booz Allen Hamilton (BAH). BAH found that the Institution's internal controls review was conducted according to best practices and offered a number of general observations about how the Institution should improve its overall control environment. The Committee reviewed the BAH recommendations and encouraged the CFO to take the actions necessary to respond appropriately. BAH also provided a project summary and outlined the control posture of each of the 23 processes reviewed. The presentation began with a summary of the assessments of the last seven processes provided to the Committee (the first 16 having been provided to the Committee in September and October 2008). It concluded with a prioritization of all 23 processes based on the importance of each to the Institution and the risk associated with the current control posture. There was an extended discussion about the processes for recording charitable contributions and the cost of capital projects, both of which were rated red (most in need of internal control improvements). Mr. Johnson expressed his frustration with the inadequacy of

the Institution's systems for tracking contributions. CFO Maroni outlined the anticipated steps to address these issues that the Smithsonian will take, which include engaging the process owners to (1) prioritize the proposed recommendations to strengthen internal controls, (2) conduct an analysis of resource requirements, and (3) develop a phased approach for implementation of the control improvements recommended. Chairman John McCarter reiterated the Committee's expectation that they be provided cost information, timelines, and priorities at the Committee's January 2009 meeting; expressed his concern that, in the face of scarce resources, it will be challenging to prioritize recommended actions to strengthen internal controls; and acknowledged that corrective actions would take time to implement.

INTRODUCTION OF NEW COMMITTEE ADVISOR

At approximately 4:10 p.m. Committee Advisor Herb Schulken joined the meeting and was introduced by CFO Maroni. Mr. Schulken, a lifelong accounting and auditing professional who recently retired from PricewaterhouseCoopers, had been asked by Board Chair Roger Sant to serve as a non-voting advisor to the Committee. A brief discussion was held to familiarize the Committee and Mr. Schulken with each other.

At approximately 4:25 p.m., KPMG representatives Ellen Harrison, Rebecca Horton, and John Keenan joined the meeting.

GOVERNANCE REFORM #21(A): SPECIAL EVENTS SPENDING GUIDELINES

Sharon Shepard, Office of the Comptroller, then gave the Committee an update on Governance Reform #21(a): Special Events Spending Guidelines. While formally under the jurisdiction of the Regents' Executive Committee, Governance Reform #21(a) has been of interest to this Committee. She reminded the Committee of the questions posed by the Committee at its July 8, 2008 meeting, including its request that a sampling of costs associated with previous Smithsonian special events be compiled. For the sampling base, all special events organized by the Office of Special Events and Protocol for fiscal years 2007 and 2008 were reviewed and analyzed. Team #21(a) concluded that strict approval guidelines will be key to implementing cost controls. Spending guidelines have since been developed to assist employees in determining the reasonableness and appropriateness of proposed event expenses. As drafted, the guidelines provide an alternative approach to fixed spending limits or per person event cost targets. Ms. Shepard acknowledged the need for monitoring event costs on a more regular basis while noting the reasons Governance Team #21(a) did not believe that fixed spending limits for special events would be practical.

GOVERNANCE REFORM #21(B): SENIOR EXECUTIVE EXPENDITURES

Ms Shepard next provided the Committee with an update on actions taken to support the recommendations of Governance Reform Team #21(b): Senior Executive Expenditures. She reminded the Committee that this topic also was discussed at the July 2008 Committee meeting. She summarized the implementation plan that supports the reform effort and noted that the 20 recommendations were categorized as follows: 13 green, seven yellow, and none red. The green recommendations already had been implemented or were on-target to be completed as planned and included seven travel-related recommendations, three petty cash-related recommendations, and three general recommendations. The yellow recommendations were noted as partially complete and, according to management, may experience some schedule slippage due to resource shortages. Those include three recommendations related to purchase orders and travel and purchase cards, one petty cash recommendation, one recommendation concerning "Other Direct Expenditures," and two general recommendations. Committee Chair John McCarter expressed an

interest in ensuring that the Institution's orientations for new Smithsonian executives include the rules and expectations regarding senior executive expenses. Ms. Shepard informed the Committee that progress reports will be presented to the Committee as targets are met or any potential slippage occurs or is foreseen.

SENIOR EXECUTIVE EXPENSES: SUMMARY OF REVIEWS

The CFO then reported on the reviews of senior executive expenses, noting that all senior executive post-travel documents were being reviewed to determine if the travel activities were in compliance with the Federal Travel Regulation (FTR) and Smithsonian Travel Policy and to note matters that merit management's attention. The review covered the second and third quarters of fiscal year 2008. All travel authorizations and the corresponding vouchers and receipts for 53 senior executives, including the Secretary, were reviewed. The initial review identified minor violations of the Smithsonian's Travel Policy due to administrative errors. Despite the fact that mistakes still occurred, it was noted that the increased level of scrutiny in the travel approval process had resulted in travel administrative improvements, indicating that both travelers and approving officials were becoming more knowledgeable of and complying with the FTR and the Smithsonian Travel Policy.

Senior executive travel card use was reviewed to determine if the travel card use was appropriate and in compliance with Smithsonian policy and the terms of the Institution's cardholder agreement with the issuing bank. The scope of the review covered the second and third quarters of fiscal year 2008 and covered nine senior executives: the Acting Secretary, the Acting Under Secretaries, and five unit Directors. Future reports will cover all senior executives. The review concluded that travel cards were being used properly by senior executives while in travel status, but not as extensively as required by policy (e.g. for meal expenses while on travel). Some senior executives had to be reminded that the travel card may not be used for local area expenses.

SARBANES-OXLEY (SOX) DISCUSSION FOLLOW-UP

Following up on the Committee's discussion of Sarbanes-Oxley at their July 2008 meeting, CFO Maroni asked the Committee to consider three recommendations for strengthening the Institution's compliance with the provisions of Sarbanes-Oxley. She directed the Committee's attention to: Title II: Auditor Independence; Title III: Certified Financial Statements; and Title IV: Internal Control Audits.

Title II: Auditor Independence

Currently, the Institution's lead audit partner will complete a 10-year rotation on the Smithsonian engagement in fiscal year 2010 (i.e., upon completion of the audit of the financial statements for the fiscal year ending September 30, 2009). KPMG introduced a second audit partner, Ellen Harrison, to the Smithsonian engagement and a new senior manager to the audit team in fiscal year 2006. The CFO recommended adopting a modified version of the SOX provisions on auditor rotation by enforcing a five-year rotation of "lead audit partner." The Committee agreed with the recommendation and decided to implement it starting in fiscal year 2010, after the completion of the current lead audit partner's rotation.

Title III: Statement of Management Responsibility

Currently the Secretary, CFO, and Comptroller submit a written management representation letter annually to the auditors. The CFO recommended, and the Committee agreed, that the same annual written statement of management responsibility be sent to the Committee.

Title III: Tax Returns

Currently the Institution's annual tax returns are prepared by the Comptroller, reviewed by the General Counsel and others, and signed by the CFO. Starting in fiscal year 2006, the Internal Revenue Service required the use of electronic filing with a signatory registered with IRS. The Institution has one license for tax software on one computer in Crystal City, Virginia. The CFO recommended, and the Committee agreed, that the CFO continue signing the actual tax return.

Title IV, Internal Controls Review

The assessment of 23 Smithsonian financial processes was completed by November 4, 2008, and a prioritization rating based on materiality and risk associated with failure to implement improvements was presented to the Committee. It was noted that management is on track to complete, in December 2008, a requirements review and cost-benefit analysis for recommended control improvements. The CFO recommended, and the Committee agreed, that the ongoing review be completed and the implementation plan be presented to the Committee in January 2009.

IRS FORM 990 DISCUSSION FOLLOW-UP

The CFO also reviewed the impact of reporting the Smithsonian's Federal appropriations on the IRS Form 990. She informed the Committee that the most significant impact will be that the report will become "Federal-centric" throughout the return. She stated that Federal activities will dominate items reported, such as the largest program service activities; the number of key employees listed on the return; the listing of highest paid "Independent Contractors," which will include higher dollar value contracts funded with Federal appropriations; and the reporting of additional employees' compensation. She said that the Chronicle of Philanthropy and others use IRS Form 990 data to analyze not-for-profit performance and that, by including its Federal appropriations, the Institution's data will no longer be consistent with past years. She also noted that the calculation of the "cost to raise a \$1 of contributions" derived from the tax return will drop dramatically because of the additional income reflected by the Federal appropriation.

The Committee affirmed its decision to include Federal appropriations in the Institution's IRS Form 990 beginning with the fiscal year 2009 return, which will be reviewed in August 2009 by the Chairman, the Comptroller, the General Counsel, and other members of the Committee as determined by the Committee.

FORMER SMITHSONIAN BUSINESS VENTURES (SBV) CEO EXPENSES REPORT

Inspector General Sprightley Ryan reminded the Committee that she had presented the findings of her report on the former SBV CEO at the July 2008 meeting. She noted that the issue had been tabled because of a death in the family of the former CEO. She presented a resolution to close out the matter for the Committee to consider and, after some discussion, the Committee approved a resolution that established that the Committee accepted both the IG's findings and proposed corrective actions.

The Committee adjourned at 5:40 p.m. and met in separate executive sessions with the CFO and the IG.