MINUTES OF THE JULY 8, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On July 8, 2008, the Regents' Audit and Review Committee ("the Committee") met at 9:00 a.m. in the Regents' Room in the Smithsonian Castle. Committee Chair John McCarter, Committee member Robert Kogod, and Ex Officio member Roger Sant participated by teleconference. Dr. Shirley Ann Jackson and Congressman Sam Johnson were unable to participate in the meeting. The Committee proceeded to discuss the matters before it, but did not take action on any matter because it lacked a quorum. Assistant to Representative Sam Johnson David Heil attended in person. 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; Director of the Office of Contracting and Personal Property Management (OCon&PPM) Robert Fraga; Associate General Counsel Lauryn Guttenplan; General Counsel John Huerta; Office of the Regents Program Manager Grace Jaeger; Chief of Staff to the Regents John K. Lapiana; Office of the Comptroller, Financial Policies and Procedures Manager Salim Mawani; Assistant Inspector General for Audits Stuart Metzger; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; Office of Contracting and Personal Property Management Analyst Curtis Sanchez; Office of the Comptroller Budget Analyst Sharon Shepard; Chief Information Officer Ann Speyer; Deputy Comptroller Stella Whitsell; and Comptroller Andrew Zino. Also in attendance were John Keenan and Ellen Harrison, 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 and asked everyone in the Regents' Room to introduce themselves so that those on the phone would know who was present. Mr. McCarter then turned the meeting over to CFO Alice Maroni. The CFO noted that a lot of staff were present to support the Committee's discussion of governance reform, the meeting's principal agenda topic.

Governance Reform Overview

The CFO said that governance reform continues to be a main focus of the Smithsonian staff. She noted that the Office of the Regents has reported that 19 of the 25 reform recommendations across the Institution have been completed, observed that the Institution's progress was recently validated by the Government Accountability Office, and identified a number of policies that have been clarified and newly promulgated as a consequence of ongoing governance reform efforts. Nine governance reform items were originally referred to the Committee. Two items pertaining to committee charters and financial disclosure have been addressed. The CFO noted that two items pertaining to the adequacy of resources remain open, including the adequacy of the resources for the Office of the Inspector General, which was on the Committee's agenda. The five reform items that remain were also on the agenda for discussion. She reminded the Committee that a consultant has been engaged to review the resources analysis for the Office of the Chief Financial Officer and that its findings will be presented to the Committee in September 2008. The last remaining staff-led governance reform team on internal controls will report to the Committee at its September and November meetings and will continue to work through the end of the year. Before turning to the review of the individual governance reform items on the agenda, she noted that action on the proposal by the Independent Review Committee (IRC) to audit the expenses of former Secretary and Mrs. Small has been completed and revised 1099s have been issued as appropriate for the relevant open tax years.

Governance Recommendation #20(a): Applicability of Smithsonian Policies to Smithsonian Business Ventures

Salim Mawani of the Office of the Comptroller informed the Committee that the planned actions of Governance Team #20(a) have been completed. He reported that the Team performed a bottom-up review of all 113 Smithsonian Directives (SDs) and identified only three long-standing practices by Smithsonian Business Ventures, now know as Smithsonian Enterprises (SE), that require exception to policy and, pursuant to Regent direction, require re-approval as exceptions to policy. Mr. Mawani explained that the three SE practices are driven by the automated systems on which SE financial procedures are dependent. Because SE uses different information technology to operate its financial accounting system and outsources its payroll process, it will be unable to comply with certain of the Institution's financial management policies contained in SD 301, 302, and 311.

Mr. Mawani reported that SE is working with OCon&PPM to conform to the Institution's contracting and personal property management policies, SD 314 and 315, and that SE is in full compliance with SD 312 for travel and Trust compensation. He also noted that the top-down review identified two necessary magazine business practices not covered by Institution policy: making contributions to non-profit organizations to cultivate advertising clients and entertaining potential advertising clients, both of which will be incorporated into a future SD. In addition, Mr. Mawani informed the Committee that the Team has developed an application process, known as a Request for Official Policy Exception (ROPE) form, for SE and other Smithsonian units to request a policy exemption and to document the Secretary's decision. The ROPE procedures will be set forth in SD 100. He said that SE is expected to submit all their ROPE applications in the near future. The Team recommended an assessment of other selected Smithsonian units to determine the need for additional ROPE applications for policy exception; it also noted the lack of awareness of Institution policies generally. The Secretary agreed that staff must be held accountable, and that he will reinforce the need for accountability and integrity, as well as awareness of and compliance with policies.

Mr. Sant asked what problems are created by the use of a separate accounting system by SE and Comptroller Andy Zino responded that it does not create any problems. He noted, however, his opinion that it would be easier if SE used the same financial system as the rest of the Institution.

Governance Recommendation #21(a): Special Events–Spending Policy Review and Compliance

Sharon Shepard of the Office of the Comptroller next updated the Committee on the work of Team #21(a). She reported that the objective of the Team was to deploy robust, comprehensive policies and procedures to strengthen the stewardship of Smithsonian resources and to ensure all special event expenses are appropriate to the purpose and context of the event, support the Smithsonian's mission, and not wasteful, excessive, or for personal benefit. The Team addressed key internal control issues, such as defining "reasonable" event expenses; establishing clear approval processes for special events; and identifying additional controls to ensure compliance with Smithsonian policies and procedures. Special events were divided into three categories: (A) formal events, (B) standard business-type events, and (C) informal events. An authorization process for special events spending was developed that details the approval requirements for each event category, with category A events requiring an additional level of review because of the extra expenses involved. The new policy has been circulated to multiple constituencies for feedback. The Team recommended that an annual special event plan be developed and updated quarterly by the units, that periodic post-event compliance reviews be performed to monitor adherence to Smithsonian policies and procedures, that special event training plans be developed, that unit-level event approval matrices be developed, and that Institution-wide training be rolled out. The next step is to present project overview and spending guideline documents to the Regents' Executive Committee for review and approval. All related policy documents will be consolidated into one Smithsonian Directive. A single source webpage for special event–related information will be created.

Mr. Kogod asked why there was not a per-person, per-event cost. The CFO responded that a dollar cap was not established as category A and B events will be reviewed and approved on a case-by-case basis by senior management, and individual cost elements must be considered within the context of each event. Mr. Sant said that the policy was essentially good but wanted to know how it will confirm that staff has stayed within the guidelines. The Secretary responded that the guidelines are tentative and that it would not be practicable to put hard numbers in the document at this time. He added that the plan first must be implemented, after which it can be assessed and monitored internally. Mr. Kogod asked for an estimated timetable of when the Committee would get a progress report, and the Secretary committed to making a report within the next six months.

The CFO requested that the Executive Committee approve the document so that the Institution could go forward with the proposed guidelines. Mr. Sant agreed to take the Team's report to the Executive Committee, but requested that staff prepare an overview of recent category A and B events to inform the Executive Committee's discussion.

Governance Recommendation #21(b): Senior Executive Expenses

Ms. Shepard began this discussion by defining the critical terms established by management with regard to senior executive expenses. She informed the Committee that management has elected to define "senior executives" as all Trust employees in Secretary-designated positions and Trust/Federal employees with the IRS designation of "disqualified persons," which includes anyone in a position to exercise substantial influence over the affairs of an organization at any time during a five-year period ending on the date of the transaction. Currently there are 49 "senior executive" employees at the Smithsonian, including 25 who have been designated by the Committee on Compensation and Human Resources as "disqualified persons" for IRS purposes. Ms. Shepard informed the Committee that "representational" expenses include the broadest category of business and entertainment expenses incurred for the purpose of fulfilling courtesy and social responsibilities directly associated with official duties and the Smithsonian's mission. These may include expenses for meals, travel, gifts, hospitality, and other activities that arise from the Institution's need to interact with various individuals and organizations outside the Smithsonian. Certain special events also are considered representational activities.

Ms. Shepard noted that Team 21(b) had conducted some benchmarking to identify best practices of universities, Federal agencies, and other non-profits. She summarized the various ways Smithsonian senior executives can incur expenses and outlined the recommendations of the Team to improve the audit and review of senior executive expenses.

With respect to travel expenses, as part of the overall review done by the traveler's approving official, the Acting Under Secretary for Finance and Administration reviews and approves, prior to travel, authorizations for senior executive travel if the travel is in excess of $2500, the duration is greater than five days, or any one of the following is indicated: premium-class air travel, spouse or dependent family member travel, certain car service usage, or any annual leave proposed to be taken during the trip. The CFO reviews and approves all travel authorizations and vouchers for the Secretary. The Team has recommended that this additional layer of review remain in effect, as well as the recently initiated review of all senior executive post-travel vouchers. To implement this reform, the CFO is hiring a Federal Travel Regulation expert to perform the reviews. With respect to serious travel card violations, the Team has recommended that they be brought to the attention of the CFO and discussed as warranted with the Office of General Counsel, Office of Human Resources, and the Inspector General.

The Team also recommended that the process of reviewing all purchase card transactions and petty cash for questionable items or practices be continued. The Team recommended that OCon&PPM develop a Smithsonian-wide compliance review procedure for purchase orders.

The CFO will prepare a quarterly report for the Committee summarizing the results of compliance reviews of senior executive expenditures. In addition, all documents that provide policy or procedural guidance will be incorporated into directives or handbooks and will be consolidated on PRISM in an accessible and searchable webpage. Team 21 will develop a communication and training plan to ensure the successful implementation of these recommendations. In response to a question from the Chair, the CFO confirmed that there will be expense compliance training for senior executives and their clerical support and that training delivery formats were currently under review.

The Chair asked if having the Acting Under Secretary for Finance and Administration approve certain travel events was too cumbersome for unit directors. The Acting Under Secretary for Finance and Administration responded that in the past four months she had only had to approve 10–12 trips and that considerable work had been done with administrative staffs to ensure that the process is not onerous.

The CFO reported that travel training is a problem as units are required to pay for training and have limited resources to do so. The Chair asked if travel training could be done online, to which the Chief Information Officer responded that, although a lot of training that is done online, such as EEO training and all information technology training, the complexities of travel system training mandates live instruction.

Ms. Shepard noted that the Office of the Chief Financial Officer does not have the resources to implement all the Team's recommendations. The Chair acknowledged that the Team's recommendations were ambitious and asked if there were options for finding the required resources. For instance, he asked KPMG if it would be feasible to outsource the internal audit function. Mr. Keenan responded that a number of firms do outsource or co-source internal audits. He said this can be particularly effective when specialized skills such as IT audit resources are needed, but added that it typically does not save money. The Chair asked the CFO if outsourcing had been considered. She confirmed that outsourcing has been considered many times but that the turnover rate among contractors is as high as it is for staff. The CFO added that it is important to develop in-house expertise in the conduct of internal audits, which is challenging given the tight job market for auditors and accountants. In response to another question, she said that consideration had been given to hiring retired Federal employees, but that doing so would require more Trust funds. The CFO agreed to provide a plan for the implementation of Governance Team 21(b)'s recommendations.

Governance Recommendation #25: Contracting Policy

Office of Contracting and Personal Property Management (OCon&PPM) Director Robert Fraga gave the Committee an update on the work of Team #25. Mr. Fraga reported that the pan-Institutional multidisciplinary team was formed in August 2007 under the leadership of OCon&PPM for the purpose of developing contracting policies and procedures to address Governance Recommendation #25. This recommendation advised that the Institution reaffirm its commitment to the consistent application of best practices across all contracting activities; conduct such practices with integrity, fairness, and openness and in a manner that will best achieve the Smithsonian "mission requirements"; and develop a policy to ensure adherence to these practices. To accomplish these objectives, Team 25 conducted extensive research to determine the applicability of public laws to Smithsonian contracting and the relevance of existing policies and procedures. It also benchmarked the Institution's contracting policies against other public and private sector institutions. Because of the diversity of the Institution and the broad scope of contracting activities necessary to support its mission, Team 25 decided to develop an overarching policy (SD 314 "Contracting"), supplemented by seven Procurement and Contracting Procedures Manuals (PCPM), Mr. Fraga reported that SD 314 has been issued, is available to all Smithsonian employees through the Institution's intranet, and satisfies the recommendation of the Governance Committee. He added that two of PCPM have been completed, the remaining manuals scheduled to be completed by December 2008, and the development of a supplementary PCPM is under way. The development of training programs is scheduled for the second quarter of calendar year 2009 and policy compliance reviews are to begin in fiscal year 2010. The CFO informed the Committee that all Smithsonian contracting provisions for revenue-producing contracts will be applicable to Smithsonian Enterprises.

In response to a question from the Chair about how the Smithsonian's procurement environment compares with that of the General Services Administration (GSA) and the Postal Service (other places where the OCon&PPM Director has worked), Mr. Fraga said that the Smithsonian had few established policies with regard to procurement activities and that those were generally not very flexible. He then described his implementation of business process changes that are intended to change procurement at the Smithsonian from being a tactical or transactional activity to a strategic or entrepreneurial activity. With better defined policies and procedures, the Institution will adopt best practices and improve the effectiveness and efficiency of the procurement operation while not inhibiting creativity. In response to a question from the Chair about the Institution's experience with contracts that secure quantity discounts, Mr. Fraga explained that little had been done in the past to achieve such benefits, but that such activities were being done now. He cited the recent restructuring of a computer contract with Dell as an example.

Mr. Sant stated that there is a perception that the Institution does too much sole-source contracting and asked Mr. Fraga if that was the case. He replied that he doesn't think that the Institution has a problem in this regard, although the Institution's unique needs sometimes require the use of sole-source contracts. Mr. Fraga added that he is currently working on raising the Institution's threshold required to compete a contract from $3,000 to $10,000, which would make a substantial difference in the Institution's procurement activities.

In response to a question from the Chair about the Institution's environmental strategies, given the age of the infrastructure and physical plant, Mr. Fraga reported that his office is attempting to structure contracts that take life cycle and sustainability into consideration. Mr. Kogod noted that the Office of Facilities, Engineering and Operations has developed a sustainability plan for facilities, but that a lack of funding remains a challenge. The Secretary agreed that sustainability is important because it saves money in the long term, but that the Institution needs to be strategic about its approach.

The Secretary voiced concern about the adequacy of procurement training and the importance of involving the units in the reform process, which would avoid the perception that the units are being overly regulated by the Castle. Mr. Fraga responded that his office is trying to reduce the administrative burden across the Institution and is taking measures to become less bureaucratic, which will enable the Smithsonian to have more resources to apply to its mission. The Secretary stressed that rolling out these mandates will raise significant communications issues and that it is important to convey to staff the ways in which these practices will result in additional income that can be used for the Institution's mission.

Governance Recommendation #23: Internal Controls

The CFO provided the Committee with an overview of the efforts of Team #23, which was tasked with ensuring that appropriate systems and controls are in place to produce reliable and accurate financial statements and reports and having reasonable assurance of efficient and effective operations. With a focus on the Institution's key financial processes, the Team identified a three-step process to accomplish its work: (1) determine which financial processes are key, which resulted in the identification of 19 separate processes worthy of review; (2) conduct "as is" reviews of the current internal controls associated with each of those processes; and (3) develop recommendations to correct the control deficiencies identified. She said that Team #23 is relying on the "process owners," or managers, of the numerous "Work Groups" convened to do these control assessments. In many instances, the process owners are not financial professionals and have had limited, if any, formal experience talking about and assessing internal controls. She reported that Booz Allen has been engaged to assist the Work Groups and their process owners with their assessments and for the purpose of validating their reviews. The first set of control improvement recommendations will be presented to the Committee at its September 2008 meeting and the second and final set will be presented at the November 2008 meeting. Each Work Group has been asked to answer five questions and evaluate the internal control framework with regard to the control environment, a risk assessment, existing preventive or detective controls, communication, and ongoing monitoring. Booz Allen is assessing the assessment methodologies being employed by each Work Group and will make suggestions of ways to improve the overall process as appropriate. It is supporting the Work Groups to ensure that the reviews reflect industry standards, but is not performing a Sarbanes-Oxley gap analysis. At the request of Mr. Sant, Team #23 will identify several limited financial processes to begin thinking about what it would take to be Sarbanes-Oxley compliant.

In the interest of full disclosure, the Chair stated that he is a former partner of Booz Allen and that, other than retirement health benefits, he has no financial interest in Booz Allen. Mr. McCarter made it clear that he played no role in the Smithsonian's selection of Booz Allen to review the CFO's resource assessment or to perform this consultation function on internal controls. The CFO and the Contracting Officer have confirmed with the General Counsel that the Chair was not involved in the selection of Booz Allen.

The Chair stated that he thinks it is important that the Institution start the process of moving toward becoming Sarbanes-Oxley–compliant because he thinks that such compliance is going to be required in the future. He suggested a phased approach, such as taking perhaps three steps toward becoming Sarbanes-Oxley–compliant in 2008; two steps in 2009, etc. He stated that the Institution will benefit from moving in that direction. Mr. Sant said he agreed but wasn't sure it would be possible without a gap analysis. The CFO said that she and the Comptroller would look at what could be done quickly. The Chair stated that the Institution should lead the museum community in this regard and the Secretary agreed. The CFO reported that the governance reform team on internal controls expects to complete its work by December 2008.

Inspector General Resources – Governance Reform #12

Inspector General Sprightley Ryan introduced Assistant Inspector General for Audits Stuart Metzger. Ms. Ryan remarked that she disagreed with the statement that 19 of the 25 governance recommendations are complete, as the Audit and Review Committee had not yet reviewed the resources of the Office of the Inspector General (OIG) and that the Governance Committee had not fully reviewed the Office of General Counsel's resources, as required by recommendations 12 and 10, respectively.

The Inspector General then presented her assessment of the adequacy of the resources available to her office. She stated that the erosion of OIG resources over a number of years has resulted in the elimination of the inspection and in-house IT audit programs and the loss of one investigative position. Although the fiscal year 2009 budget currently pending before Congress includes a request to hire two more auditors and one junior-level investigator or investigative analyst, the need for oversight has increased since 1994 with the addition of new museums, facilities, and programs. Other OIG oversight responsibilities continue to expand, such as the information technology security audits required by the Federal Information Security Management Act (FISMA); oversight of the Institution's annual financial statement audit; increased requests from Congress for briefings and audits; and the annual review of travel and other expenses of Smithsonian executives, to name a few.

In the last five years, her office has been unable to cover adequately the Institution's high-risk areas and has focused near-term audit coverage on four areas: modernization of financial management and accounting operations; management of capital assets; modernization and security of the information technology infrastructure; and security and care of the national collections. The Inspector General reported that planned audit projects for this fiscal year and those carried-over from last fiscal year will require about 10 staff. She informed the Committee that some of the planned fiscal year 2008 audits will not be completed this fiscal year. Additionally, while best practice is to re-audit high-risk programs every three to five years, the lack of resources has prevented her office from appropriately revisiting the Institution's financial system implementation, which was last audited in 2004, and the security and collections inventory at the museums.

With current staffing levels, the OIG is limited to completing only four to five discretionary audits annually, in addition to legislatively mandated audit work and responding to Congressional inquiries. The Inspector General stated that she would like to conduct 10 discretionary audits each fiscal year.

The Chair stated that he has concerns about the security and care of the national collections. Issues such as theft, mold, and water damage indicate that there needs to be a renewed focus on collections care and the mitigation of areas of high risk. He asked if this could be contracted out. The Inspector General responded that she will present her audit plan for fiscal year 2009 at the September Committee meeting, which will include collections care. Mr. Kogod informed the Committee that there is a request in the fiscal year 2010 budget for more museum guards. The CFO stated that, with the Regents' approval, it was management's intention to include the Inspector General's request for four additional staff in the Institution's fiscal year 2010 Federal budget request.

Inspector General's Issues Update

Inspector General Ryan reported that her office had received a request from Congressman Robert Brady (D-PA; Chairman of the House Committee on Administration) to review the implementation of the Showtime contract. As a result, her office's audit plan for the next fiscal year will include an audit of Smithsonian Networks. She informed the Committee that her office is undergoing a peer review by the Inspector General of the Federal Reserve Board. She noted that an audit will be released soon on the Institution's workers' compensation program and that she will be providing members a one-page summary of the audit before it is released to the Congress. She reported that the audit of executive travel is ongoing and was pleased to report that, thus far, the audit findings do not identify any gross policy violations, but will likely highlight ongoing issues pertaining largely to the adequacy of documentation.

She reported that the final report on the expenses of former Secretary Small and his wife has been completed, as well as the report on former Smithsonian Business Ventures CEO Gary Beer. With respect to Secretary Small's expenses, the review determined that he owed the Institution \$3,000, which he has repaid. The review also resulted in the Institution issuing a revised tax form for \$25,000 in travel expenses for Mrs. Small's travel. With respect to Mr. Beer, issues similar to those reported a year ago were discovered. Furthermore, she reported that there were still outstanding issues from her office's July 2007 report. Ms. McNally added that letters have been sent to Mr. Beer requesting him to, according to the provisions of his separation agreement, repay $9,700 for expenses lacking documentation or authorization, which remain outstanding and are in addition to $26,000 owed by Mr. Beer for previous years' unauthorized expenses.

Chief Financial Officer's Issues Update

The CFO informed the Committee that 10 offers for accounting positions have been accepted since October 2007, including four accountants dedicated to the financial statement audit. Thirteen accountant vacancies remain, six of which are dedicated to the financial statement audit and seven represent routine vacancies. On average, 52 applications have been received for every offer accepted. She told the Committee that she is using her direct hiring authority to hire Trust-funded positions. With respect to the financial statement audit, she told the Committee that her office is committed to a completion date of January 30, 2009, for the fiscal year 2008 audit and that the Office of the Comptroller is aggressively responding to the open KPMG and IG audit recommendations. With respect to the A-133 audit, she reminded the Committee that the audit is currently performed by both KPMG and the Defense Contract Audit Agency (DCAA). She reported that, after considering whether engaging DCAA was in the Institution's best interests, she is recommending to the Committee that the Institution continue to use both KPMG and DCAA for the A-133 audit, noting that it would cost considerably more to ask KPMG to do the entire A-133 audit and it would likely only accelerate the completion of the audit by about six weeks. She added that DCAA has decided to change its approach to the audit-related information it requires regarding Smithsonian Astrophysical Observatory subcontractors to complete the Institution's audit, which previously had been problematic.

It was noted that the Institution received an unqualified opinion for the recently completed fiscal year 2007 A-133 audit. The CFO also informed the Committee that at the September 2008 Committee meeting there will be a discussion on the new IRS Form 990 requirements.

There was a brief discussion of how the Institution values its investments for the purpose of its financial statement audit. The CFO reported that KPMG has a dedicated auditor who specializes in these matters and that the auditor works closely with the Institution's Office of Investments and the Office of the Comptroller to satisfy the requirements of the audit.

Executive Sessions

The Committee adjourned at 11:30 a.m., after which three individual executive sessions were conducted with the Inspector General, the CFO, and KPMG.