MINUTES OF THE SEPTEMBER 18, 2008, AUDIT AND REVIEW COMMITTEE MEETING

On September 18, 2008, the Regents' Audit and Review Committee ("the Committee") met at 2:00 p.m. in the Regents' Room in the Smithsonian Castle. Committee Chair John McCarter and Committee member Congressman Sam Johnson participated by teleconference. Committee member Robert Kogod and *ex officio* member Roger Sant attended in person. Dr. Shirley Ann Jackson was unable to participate. Staff present at the meeting were Secretary G. Wayne Clough; Executive Assistant to the Secretary Patricia Bartlett; 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 Manager Grace Jaeger; Chief of Staff to the Regents John K. Lapiana; Office of the Comptroller, Financial Policies and Procedures Manager Salim Mawani; Inspector General (IG) Sprightley Ryan; Acting General Counsel Marsha Shaines; Deputy Comptroller Stella Whitsell; and Comptroller Andrew Zino. Also in attendance were John Keenan, Ellen Harrison, and Rebecca Horton who represented the Institution's auditors, KPMG LLP. Assistant to Congressman Sam Johnson David Heil participated by teleconference. Minutes were taken by Susan Block, special assistant to the CFO.

Committee Chair John McCarter opened the meeting. The Committee proceeded to discuss the matters before it, but without a quorum at the outset, did not take action on any matter until Mr. Johnson joined the meeting in progress.

KPMG Audit Plan

Mr. Keenan, senior partner with KPMG LLP, told the Committee that the audit plan for fiscal year 2008 was similar to the plan used in fiscal year 2007. He reported that the engagement team was unchanged from that used last year, except for the additions of Katie Bishop, the new concurring partner for the audit of the entity-wide financial statements, and Donna Garcia, a manager to assist Rebecca Horton. He stated that the scope of work and reporting requirements were the same as in fiscal year 2007. He reported that KPMG is working with the Office of the Inspector General (OIG) to perform a separate audit of the Smithsonian Enterprises' (SE) net gain calculation. Mr. Keenan added that the details of that engagement had recently been worked out and that a contract change order to include this audit in the scope of work for fiscal year 2009 was in process. As with last year, KPMG is closely coordinating its work with the OIG and the Office of the Comptroller.

Mr. Keenan introduced Ms. Horton who discussed the main areas of emphasis for the audit. She reported that there are three areas of emphasis: recurring transactions; nonroutine transactions; and key accounting estimates and other. She stated that the bulk of the audit will be spent reviewing recurring transactions, which include compliance with the terms of Federal appropriation and other Federal awards; cash disbursements and payroll; contributions; investment purchases and sales; satisfying donor restrictions; debt financing and compliance with related debt covenants; SE catalog and magazine operations; and other arrangements. She noted that there are two new standards affecting the Smithsonian audit this year: adoption of the uncertain tax positions accounting standard and the net asset classifications and disclosures for donor-restricted endowment funds.[1]

Ms. Horton introduced Ms. Harrison who addressed the audit of the Institution's nonmarketable investments. She stated that a significant time will be spent gaining an understanding of and testing key internal controls over the valuation of these investments. She noted that all significant investment holdings with fund managers will be confirmed as of September 30, 2008, and that audited financial statements for these investments will be reviewed with a focus on the type of audit opinion issued, period covered, basis of accounting, and management's reconciliation of audited net asset values to amounts owned and recorded by the Smithsonian. She noted that KPMG will also test rollforward analyses of activity from the investees' audit dates (primarily December 31, 2007, to September 30, 2008) and review management's benchmarking analyses supporting the year-end valuations of all significant nonmarketable investments. She informed the Committee that this year's KPMG engagement team again will include a senior financial service manager working with the Office of Investments.

Ms. Horton then discussed fraud risk responsibilities. She stated that KPMG would evaluate the incentives and pressures on Smithsonian staff; assess fraud opportunities; understand the attitude of management; and consider management's knowledge of suspected fraud. She stated that KPMG will be providing documentation to the OIG in their role as the audit's Contracting Officer's Technical Representation and that KPMG meets regularly with the OIG staff. KPMG will monitor the scope, timing, and findings of separate reviews performed by the OIG and will review all reports issued by the OIG. The OIG and KPMG will share information and perspectives on accounting and internal control matters.

Ms. Horton then discussed the audit timetable and reported that KPMG began field work in July 2008. She noted that the "Federal closing package" financial statements are due on November 17, 2008, and that January 31, 2009, is the target date for issuance of the Smithsonian's 2008 entity-wide financial statements. She reported that communications with the Committee will be the same as in previous years and that a management letter will be prepared that will include significant deficiencies and material weaknesses (if any), as defined in *Statement on Auditing Standards* No. 112.

On the subject of the fiscal year 2007 A-133 audit, Ms. Horton noted that the A-133 audit was coordinated with the Defense Contract Audit Agency (DCAA) and that an unqualified opinion was issued. She noted that there were two minor deficiencies, which did not affect the opinion.

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[1] The latter is in response to the Uniform Prudent Management of Institutional Funds Act and the Financial Accounting Standards Board's Staff Position (FSP) 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, and Enhanced Disclosures for All Endowment Funds.

Application of the Sarbanes-Oxley Act to Not-for-Profits

In response to the Committee's request in July 2008, Ms. Harrison presented a briefing on the applicability of the Sarbanes-Oxley Act to not-for-profit organizations (NPOs). She informed the Committee that Sarbanes-Oxley generally applies to U.S. public companies and not to the Smithsonian or the not-for-profit community. However, certain provisions are applicable to non-profits and others may be adopted as best practices by non-profits. She reviewed each of the law's provisions that might be regarded as applicable to the Smithsonian.

Title II (Auditor Independence) of the Act requires a five-year rotation of audit partners; approval of all services by the audit committee; prohibition of certain non-audit services; disclosure of critical accounting policies and practices; and safeguards against auditor conflicts of interest. While Title II is not applicable to NPOs, the Smithsonian has adopted the non-audit services provisions. She stated that most NPOs who have adopted a five-year rotation have implemented a less restrictive five-year rotation policy with regard to the lead audit partner. KPMG introduced a second partner to the financial statement audit team to provide a fresh look with the start of the fiscal year 2006 financial statement audit. With respect to their non-profit practice, the KPMG lead partner rotates every 10 years. John Keenan, the Smithsonian's lead audit partner, is scheduled to rotate off the Smithsonian's account for the fiscal year 2010 audit. Chief Financial Officer (CFO) Alice Maroni stated that the Smithsonian is in compliance with Title II with the exception of the five-year audit partner rotation standard.

In response to a query about whether any non-profit organizations have fully complied with Sarbanes-Oxley, Mr. Keenan said that KPMG is unaware of any non-profit organization that has found it cost-effective to become fully compliant with Title IV, Section 404 (Internal Controls).

The Chair stated his view that, if asked, the Institution would be correct stating that, with regard to the sections of Sarbanes-Oxley that apply to the Smithsonian, the Institution is in compliance. The Chair requested that KPMG and the CFO draft a short statement for the Secretary to use, if asked. With respect to audit partner rotation, the Committee asked KPMG to provide an analysis of the pros and cons of following a five-year versus a 10-year rotation cycle. The Chair stated his preference for following a five-year cycle, unless a compelling reason exists for a longer cycle.

Ms. Harrison said that Title III, Section 301 (Independent and Competent Audit Committee) is not applicable to NPOs but noted the unique status of the Regents' Audit and Review Committee, as it includes members who are knowledgeable in NPO operations; selects and oversees the Institution's audit firm, in conjunction with the OIG; and has used Governance Reform #12 to strengthen the reporting relationship of the OIG to the Committee.

The CFO said that the Committee continues to seek a non-Regent "financial expert" member. Mr. Sant indicated that he and the Committee Chair have interviewed a possible candidate who will now be interviewed by the Secretary. He stated that this individual is willing to be either a Committee member or a financial expert advisor. Mr. Kogod stated his preference for the individual to be a Committee member, not merely an advisor.

Ms. Harrison reported that Title III, Section 302 (Certified Financial Statements) is not applicable to NPOs. She explained that it is difficult for NPOs to comply with this section because it requires a signature on Securities and Exchange Commission reports 10K or 10Q, which NPOs do not file. The CFO noted that, in addition to the management representation letter currently prepared annually for KPMG, the Secretary could sign the 990 or a separate letter to the Audit and Review Committee. She indicated that she would make a recommendation to the Committee for their consideration at the next meeting.

With regard to Title IV, Section 402 (Insider Transactions and Conflicts of Interest), Ms. Harrison reported that the CFO and General Counsel think the Smithsonian is in compliance with this regulation because no loans are made to any directors or executives. The Smithsonian Statement of Values and Code of Ethics, adopted by the Regents in January 2008, provide guidance for ethical practices expected of individuals acting on the Institution's behalf. Inspector General (IG) Sprightley Ryan asked if there were specific written policies forbidding loans to directors or executives and Acting General Counsel Marsha Shaines responded there were not. It was suggested that written policy be developed, and the Ms. Shaines said that could be done.

Title IV, Section 404 (Internal Control Audits), is not applicable to NPOs, including the Smithsonian. Ms. Harrison stated that NPOs, including higher education and large philanthropic organizations, have not adopted this provision due to the significant implementation costs and the perception that the costs outweigh the benefits, particularly in the nonprofit environment. She noted that the Institution had begun to document its financial internal control processes as part of Governance Reform #23 and had a phased plan to implement internal control improvements. Management included funding in the fiscal year 2010 Federal budget request for this purpose.

Title VIII, Section 802 (Document Destruction), is applicable to NPOs. The CFO reported that the Smithsonian is in compliance, as the Smithsonian's document retention policy mirrors the Federal standard of retaining documents for six years and 10 months.

Title VIII, Section, 806 (Whistle-Blower Protection), is applicable to all NPOs. The CFO reported that the Smithsonian is in compliance as the Institution's policies conform with the Inspector General Act of 1978, Title 5, Appendix 7, which provides employees protection from reprisal for any "whistle blower" activities.

New Internal Revenue Service (IRS) Form 990 Process

Comptroller Andrew Zino reported that, effective for fiscal year 2009, the new IRS tax reporting form presents a radical shift for the Institution in the depth, breath, and scope of information required to complete the return. It is the most significant change in tax reporting for NPOs in almost 30 years and goes well beyond requesting "tax information" and addresses areas of policy and governance, giving new focus to the oversight role of an organization's governing board. The new form requires many new schedules to be completed and will require the participation of Smithsonian units outside the Offices of the Comptroller and General Counsel. The Institution will be required to complete all 11 parts of the "core form" and 13 of the 16 additional schedules. The Board of Regents will need to determine the extent of the Regents' engagement given the IRS expectation of governing board oversight. To collect the data necessary, the ERP financial reporting system will need to be modified to capture detailed financial information not currently collected by the ERP system. It was noted that there may be more extensive public scrutiny of activities in response to the increased scope of reported information. The Comptroller requested guidance from the Committee on the level of their involvement in the new process.

The Acting General Counsel then remarked that the Institution submitted museum-specific comments on the Institution's collections to the IRS when the new Form 990 was still in draft and that the IRS adopted those comments. She said that the Smithsonian historically reported only Trust data on the Form 990 and that the new Form 990 has raised the question whether Federal data should also be reported. Adding Federal data to the form would dramatically alter the analysis often done using the information contained the IRS filing. It was noted that the National Gallery of Art and Kennedy Center report both Federal and non-Federal expenses in their Form 990 filing. The Committee decided that both Trust and Federal data be reported and that a special all- or half-day meeting of some or all of the members of the Committee should be scheduled to review the completed Form 990 prior to its filing.

Governance Reform: Internal Controls and Resources for the Office of the Chief Financial Officer

The CFO provided an update on the review of the Institution's financial reporting systems and internal controls. She reported that independent consultant Booz Allen Hamilton has confirmed that the review is being conducted according to best practices using the internationally accepted evaluation methodologies established by the Committee of Sponsoring Organizations of the Treadway Commission (known as COSO). Governance Team #23 originally identified 19 critical control processes for review. Booz Allen recommended the addition of four more processes due to their materiality and the potential risk associated with inadequate controls. Booz Allen also offered three key observations and recommendations pertaining to the need to (1) strengthen the Institution's culture of accountability, beginning with the Secretary and his leadership team; (2) use more explicit performance evaluation criteria in management and employee performance plans to reflect the importance of policy compliance and adherence to controls; and (3) provide additional dedicated staff and program resources to strengthen internal controls in priority areas.

With respect to the review, the CFO reported that the assessment of eight of 23 critical processes had been completed. In consultation with Booz Allen, Team #23 prioritized the eight processes based on their risk to the Institution if control gaps were not addressed. Risks were categorized as high, medium, or low and were discussed at length by the Committee. Booz Allen agreed with Team #23's assessment that additional resources and staff are needed to mitigate some of the risks that have been identified.

The CFO noted that the Institution's leadership supported her request for fiscal year 2010 Federal funding to strengthen internal controls in all the processes under her immediate purview. She reported that the internal controls review would be completed in November 2008, presented to the Committee at its November 2008 meeting, and included in the Committee's subsequent report to the Board of Regents. She stated that the work on internal controls would not end there. Work will continue on preparing the necessary cost-benefit analyses, establishing priorities, and securing the resources necessary to strengthen internal controls.

Mr. Sant stated that he thought that the Board of Regents expects the CFO to have a full implementation plan by January 2009. The Secretary expressed his concern that a broader perspective be considered with regard to this plan, saying that strengthening these internal controls should be part of a pan-Institutional effort to identify and address other critical requirements necessary to the fulfillment of the Smithsonian's mission.

Office of the Chief Financial Officer: Adequacy of Resources

In response to the Committee's direction to the CFO to engage a third party to evaluate the CFO's Resource Assessment and Plan presented to the Committee in April 2008, the CFO provided the results of the Booz Allen study. Booz Allen was engaged to assess whether the appropriate methodology was used and whether the findings and recommendations were reasonably derived from the application of that methodology. The Booz Allen analysis concluded that the methodology was appropriate and the findings and recommendations were reasonably derived. The study observed that it was not possible to assess the resource requirements associated with the upcoming national campaign, as its size and scope have not yet been established. Booz Allen validated the unmet resource needs of the Office of the CFO, which was based on interviews, Smithsonian documentation, audit findings, and internal studies.

Inspector General's Audit Plan and Issues Update

Inspector General Sprightley Ryan reported that her office is continuing to work on the travel audit. She said that although some considerable errors in documentation had been discovered, no instances of extravagant travel had been found and that most Smithsonian travelers are frugal travelers. The audit on workers' compensation is progressing. She said that she hopes to have a final report on the expenses of the former director of the National Museum of American Indian by mid-October 2008, which will be sent to the Congress. She reported that the OIG had just undergone a peer review and that a clean opinion will be issued. She reported that her senior auditor retired in September 2008, one new auditor has reported for duty, another will come in October 2008, and perhaps two more will arrive in November 2008. She said that she is meeting with each Smithsonian director individually to get acquainted, familiarize them with her office, and learn about their issues. The Chair noted his support for the OIG's focus on collections security and inventory.

Chief Financial Officer's Issues Update

Following a brief introduction, there were no questions for the CFO, who had provided a written issues update in advance of the meeting. It was noted that, in a separate mailing, the CFO provided the Committee with a status report on the hiring of audit accountants, which indicated that six of the eight funded positions have now been filled.

Approval of Minutes

A motion was made and seconded and the minutes of the March 3, April 16, and July 8, 2008, meetings were approved.

Executive Sessions

The Committee adjourned at 3:40 p.m., after which four individual executive sessions were conducted with KPMG, the Inspector General, the CFO, and the Committee alone.