MINUTES OF THE APRIL 7, 2010, AUDIT AND REVIEW COMMITTEE MEETING

On April 7, 2010, the Regents' Audit and Review Committee ("the Committee") met in the Regents' Room of the Smithsonian Castle. Participating were Committee Chair John McCarter* and Committee members Shirley Ann Jackson** and Robert Kogod; Committee member Sam Johnson was unable to participate. Also participating were Assistant to Congressman Sam 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; Smithsonian Enterprises Chief Financial Officer Gregory Bokman; Office of the Inspector General Financial Audit Manager Bruce Gallus; Associate General Counsel Lauryn Guttenplan; Chief of Staff to the Board of Regents John K. Lapiana; General Counsel Judith Leonard; Chief Financial Officer (CFO) Alice Maroni; Under Secretary for Finance and Administration Alison McNally; Director of Government Relations Nell Payne; Inspector General (IG) Sprightley Ryan; and Comptroller Andrew Zino. Also in attendance were Ellen Harrison, John Keenan, and Liz Lawson, who represented the Institution's external auditors, KPMG LLP. Minutes were taken by Susan Block, Special Assistant to the CFO.

Chairman John McCarter called the meeting to order at 2:00 p.m.

Update on Best Practices Study

The Chair asked Secretary Clough to give the Committee an update on the best practices study being done by McKinsey & Company. While the study is not under the purview of the Committee, the Committee is nevertheless quite interested in tracking its progress. The study is looking at where the Institution can do better, what the Institution should be doing that it is not, and the organizational structure of the Smithsonian, and will make numerous recommendations based on its findings. It is part of the foundation-strengthening process that will help the Smithsonian achieve the ambitious goals of the strategic plan and successfully launch the national Campaign. McKinsey & Company has conducted extensive interviews across the Institution and is approximately two-thirds through phase one of the project. The consultants have identified seven different organizational structures used by the Smithsonian since 1990, reflecting both a functional-based and a subject-area based orientation. An external advisory committee of individuals with extensive experience in not-for-profit organizational studies was organized under the auspices of the Finance Committee and is monitoring the work of the consultants.

Review of the Fiscal Year 2009 Financial Statement Audit and Secretary's Statement of Management Responsibility

Comptroller Andrew Zino informed the Committee that the fiscal year 2009 financial statement audit was extremely successful and commented on significant matters reflected in the statements. The Institution's total operating revenues were up almost $80 million over fiscal year 2008. Most of that increase was due to an increase in revenue recognition for federal appropriations offset by a slight decrease in government grant and contract

**participated by teleconference*
***joined meeting at 2:30 p.m. by teleconference*

revenues and a small reduction in business activities. There was also an increase in expenses of about $52 million. With the increase in operating revenues exceeding the increase in expenses, there was a positive increase in net assets from operations. Overall, net assets increased by approximately $80 million during fiscal year 2009, including the results of non-operating activities. There were a number of significant changes in the notes to the financial statements in fiscal year 2009 due to new accounting pronouncements that the Institution adopted during the fiscal year, including the Statement of Financial Accounting Standards No. 157 (FASB 157, which relates to fair value measurements and disclosures) and FASB Staff Position 117-1 (FSP 117-1, which relates to the presentation and disclosure of endowment funds). Compliance with these pronouncements required significant effort on the part of staff in the Office of the Comptroller and the Office of Investments and resulted in five new pages of footnotes in the financial statements. In keeping with best practices for not-for-profit organizations, the Committee was provided copies of management's statement of responsibility, which was signed by the Secretary and CFO to attest to the accuracy and fairness of the financial statements, to the best of their knowledge and belief.

Review of the Audit Results and Management Letter

KPMG LLP Senior Partner John Keenan introduced Ellen Harrison and Liz Lawson and reminded the Committee that the audit was under way when the Committee last met. The audit of the Smithsonian-wide financial statements was completed on time on January 29, 2010. The audit of the Smithsonian Enterprises (SE) special-purpose financial statements was completed on January 29, 2010, also on time. Mr. Keenan reported that both audits went very smoothly this year.

Ms. Harrison fulfilled the required communications to the Committee on the audit of the Institution for fiscal year 2009, noting that management cooperated fully with the audit. KPMG issued an unqualified opinion on both the Smithsonian and SE financial statements. There were no changes in significant accounting policies in fiscal year 2009 and no significant unusual transactions. As discussed by Mr. Zino, the Institution applied FASB 157 and FSP 117-1 for the first time. SE, however, did not change the application of its existing accounting policies during fiscal year 2009. KPMG evaluated the key factors and assumptions used by management in making accounting estimates and judgments that were significant to the financial statements and concluded that each appeared reasonable. Management determined, and KPMG concurred, that some uncorrected audit differences that were not recorded were immaterial.

With regard to the Management Letter, there were no material weaknesses or significant deficiencies noted. Other comments noted in the fiscal year 2009 financial statement audit concerned the need to enhance controls that address contribution accounting, sponsored projects accounting, and the reconciliation and analysis of restricted net assets. KPMG recommends that the Institution develop an Institution-wide policy on administrative fees and that it be communicated to donors. Ms. Harrison also summarized the fiscal year 2008 audit comments that were resolved during fiscal year 2009.

Ms. Lawson then discussed the SE audit. KPMG received great cooperation from SE management and that many improvements were made in the last year. KPMG had one recurring comment, noting the need for formalized inventory valuation policies. She also summarized the fiscal year 2008 SE audit comments that were resolved during fiscal year 2009.

Advisor to the Committee Herb Schulken asked KPMG about the apparent Smithsonian decision not to implement or adopt the Uniform Prudent Management of Institutional Funds Act (UPMIFA). CFO Maroni noted that the Smithsonian intends to implement UPMIFA, but deferred this action because the adoption of FASB 157 and FSP 117-1 in fiscal year 2009 required the implementation of a large volume of new disclosures. The Institution intends to adopt UPMIFA in fiscal year 2011. Ms. Harrison stated that UPMIFA is a law that has been adopted by the vast majority of the states and the District of Columbia. However, the Smithsonian is not required to adopt this regulation.

CFO Maroni noted that there is some uncertainty about which Regent Committee will be asked to approve the implementation of UPMIFA, but said that she believes the Investment Committee will assume this responsibility.

Mr. Schulken asked about the unadjusted audit differences noted by KPMG. He observed that the Smithsonian's unadjusted differences appeared to be about 24 percent of "net income" (i.e., the change in net assets for the year) and asked if that reflected a material adjustment. Management has made the judgment that these unadjusted differences are non-material. Ms. Harrison replied that, for non-profits, KPMG does not look solely or primarily at the effect of unadjusted differences on the change in net assets for the year when assessing materiality from their perspective. The focus is more on the effect of the differences on net assets and liabilities. The most significant unadjusted difference relates to the accounting for conditional asset retirement obligations (e.g., asbestos remediation costs), which is a recurring difference. This difference is one of several non-material accounting differences, fully disclosed in the attachment to the Institution's Representation Letter on unrecorded audit differences..

Approval of the Minutes

A motion was made and seconded, and the minutes of the Committee's January 13, 2010, meeting were approved.

Review of KPMG Partner Succession

Mr. Keenan reminded the Committee that, in executive session at the Committee's January 2010 meeting, the subject of selecting his successor as the lead partner on the Smithsonian had been discussed, with emphasis on the process involved. The subject was much discussed in the intervening months by KPMG internally and with the Committee Chair, the Advisor to the Committee, the CFO, the Comptroller, and the IG. As a consequence of those discussions, KPMG recommended that Ellen Harrison serve as the new lead partner on the Smithsonian audit engagement. Ms. Harrison has worked on the Smithsonian audit as a second partner since 2007 and her audit specialty is non-profit organizations.

The Committee was informed that no motion was required for this action. The Chair thanked Mr. Keenan and welcomed Ms. Harrison in her new role. In response to a question about the client service partner, Mr. Keenan said that KPMG would propose that Candice (Candy) Duncan, KPMG's managing partner for the Washington, D.C., area, take on this role. Mr. Keenan agreed to set up separate meetings for the Secretary and the Committee Chair to get acquainted with Ms. Duncan.

The Committee approved a resolution recognizing Mr. Keenan's 10 years of exceptional service and the Secretary presented Mr. Keenan with a framed copy of the resolution.

Review of the Office of the Inspector General Quality Assurance Report on the Financial Statement Audits

Inspector General (IG) Sprightley Ryan introduced Financial Audit Manager Bruce Gallus, who summarized the results of the IG's review of the audit. Great progress has been made in the audit over the past four years. There were no significant deficiencies in the fiscal year 2009 audit and fiscal year 2008recommendations were largely resolved. Mr. Gallus expressed concern that the Institution would be able to maintain this level of performance in light of the recent departure of the Deputy Comptroller. A potential candidate for the position has been identified and a new Deputy Comptroller may be appointed within a few weeks.

Mr. Gallus reviewed aspects of the audit process that were previously identified as in need of strengthening. The progress assessment noted that improvements in communication have been made and that the Office of the Comptroller and KPMG continue to work on implementing a plan for more detailed testing of interim account balances; it also urged management to work harder to produce quarterly financial statements. With respect to internal controls, management was commended for the work that has been done to update Smithsonian directives with implications for financial procedures. Smithsonian Directive (SD) 115, Management Controls, which forms the basis of the Institution's overall control structure, is undergoing a comprehensive revision with an early fiscal year 2011 completion date planned.

In response to a question about the impediments to quarterly financial reporting, the CFO noted that, in response to the Finance Committee's request, quarterly financial reports are being developed on the Institution's budget and performance to date. She explained that the work being done is not classic financial statement reporting but is nevertheless useful and asked if this was suitable. Mr. Gallus said that, although he understands it is management's perspective that GAAP-based quarterly financial statements would be cost-prohibitive to produce, budgetary reporting is not a substitute for quarterly financial statements. He proposed that a cost-benefit analysis be done to develop some form of quarterly reporting of historical financial results that is meaningful and economical. The IG and the CFO will agree on a course of action and update the Committee in a timely manner. The CFO and Comptroller also will prepare, in concert with the IG, a written response to the Committee on the status of the directives identified by the IG.

Inspector General Ryan updated the Committee on her office's audit of physical security and inventory control measures to safeguard the collections of the National Air and Space Museum (NASM), which was issued on March 17, 2010. While NASM's security is generally adequate to safeguard the collections in terms of physical security and inventory control, the audit determined that none of the Museum's high-security storage areas have all of the security devices required by Office of Protection Services (OPS) standards. Although OPS does not agree that the collections are at risk, the Director of NASM agreed with the recommendations and has already implemented some of them. The IG stated that the Institution needs an Institution-wide collections storage plan.

The IG informed the Committee that March 31, 2010, will conclude the semiannual reporting period. The report of the IG will be submitted to Congress at the end of April 2010.

The Chair reported on his conversations with the IG about collections security and his March 17, 2010, meeting with OPS Director J.J. McLaughlin to discuss overall security issues. He emphasized his continuing interest in the security of the collections and commended the IG for the pamphlet "Understanding the OIG Audit Process."

Internal Revenue Service (IRS) Form 990 Review Process for Fiscal Year 2009

The Committee considered a motion to recommend to the Board of Regents that the review of the IRS Form 990 be delegated to the Committee on behalf of the Institution. The new Form 990 specifically asks for a description, which will appear in Schedule O of the tax return, of the process used by the Institution to review the tax return before it is filed. The purpose of the proposed motion is to formally document that a subcommittee comprised of the Committee Chair, the Comptroller, and the Advisor to the Committee will go through the details of the tax return. The complete draft return will be presented to the full Committee at a meeting in August 2010, shortly before the required filing of the return.

The sequence of the review process will begin with the creation of the document by OC staff, after which the Comptroller will perform a detailed review of the numbers and reconcile the total amounts back to the audited financial statements; the Office of General Counsel will conduct a technical review of the return; and KPMG's tax department will conduct a final technical and compliance review, if deemed necessary. The subcommittee of the Committee will then review the return. In August 2010, the return will come to the full Committee for final review. To complete the review process, an electronic version will be provided to the Board of Regents for information purposes only; no action will be required of the Board.

The Committee unanimously approved the following resolution to recommend that the Board of Regents authorizes the Audit and Review Committee to review the IRS Form 990.

> **VOTED** that the Audit and Review Committee recommends that the Board of Regents delegates the review of the Smithsonian Institution's annual Internal Revenue Service Form 990: Return of Organization Exempt From Income Tax Information Return to the Board's Audit and Review Committee.

Update on Insurance Coverage

Treasurer Sudeep Anand discussed the impact of the building collapse at the Garber facility in Suitland, Maryland, during the February 2010 snow storm. The building provided off-site storage for some of NASM's collections, including 1,200 art objects and three dimensional objects such as plane parts, and was unsafe for entry for several weeks. The building has now been shored-up and staff has begun to move the objects out. In terms of collections insurance, the Institution does not have replacement insurance but the policy has a clause indicating that the Institution can spend up to $25 million on restoration. In terms of property damage, part of the building is Federal property and not insured but some of the building's contents, such as shelving, may have been purchased with Trust funds, which would be covered with a $10,000 deduction. NASM is determining which property was purchased with Trust funds and would be available for replacement by insurance proceeds.

Update on Internal Controls Improvement Progress

CFO Maroni reported on the progress being made to improve internal controls associated with the five processes identified as high risk. There continues to be some risk to the schedule to remediate control deficiencies. The Committee discussed the limited impediments to progress that have been identified, which are largely a combination of not yet having necessary staff and systems. Going forward, the CFO will provide specific comments on the high-risk areas.

The meeting was adjourned at 3:25 p.m. The Committee then conducted separate executive sessions with KPMG, the Inspector General, and the Chief Financial Officer, after which it met alone.

Respectfully submitted,
John McCarter, Chair