Smithsonian Institution
Office of the Inspector General

In Brief

Executive Compensation at Smithsonian Business Ventures, Phase I

Report Number A-06-02, January 19, 2007

Why We Did This Audit

Our objectives were to assess how SBV establishes and documents executive compensation; whether payments were in compliance with policies and procedures; and the reliability of the revenues and other data used to calculate compensation. In Phase II of our coverage, we will examine the sources and reliability of the financial and performance data used to calculate compensation in more depth, as well as SBV's oversight of contractor net revenues.

What We Recommended

We made eight recommendations to correct observed weaknesses. To strengthen its compensation process, for example, SBV needs to document justifications for giving incentive payments when incentive goals were not met. Also, SBV's key financial measures should be examined by a third party to ensure reliability. Finally, SBV's market-based compensation model needs reevaluation.

Management concurred with our recommendations.

What We Found

Overall, Smithsonian Business Ventures (SBV) has a comprehensive compensation process, and executive compensation is within the range of similar non-profit and commercial enterprises. However, SBV does not always follow its policies and procedures. A small percentage of the individuals we sampled received incentive awards despite not meeting performance goals, although the total sums awarded were relatively small. Operational goals were sometimes vague, making measurement of performance difficult. And while financial goals were established and approved in a timely manner, operational goals often were not. Many executives in our sample also lacked written performance appraisal summary ratings. In addition, SBV lacked a disciplined process for establishing, approving, and reconciling long-term strategic plans.

SBV's accounting system had weaknesses, many of which SBV had identified. SBV generally was tracking and accumulating only large out-of-period adjustments and not assessing the cumulative impact of smaller out-of-period adjustments on its net gain calculations. Because of the importance of SBV's net gain to the Smithsonian and to the calculation of SBV executive compensation, greater assurance is needed that SBV financial results are accurate.

Finally, while SBV has contributed significantly to the Smithsonian since its inception in 2000, its overall inflation-adjusted net gains have declined. The dollar value of SBV's contribution to the Smithsonian is lower, in real dollars, than the amount Smithsonian businesses contributed in 1999. Nonetheless, total executive compensation as a percentage of net gain has grown modestly from 8 percent to 11 percent over the period. Finally, SBV's 2006 net gain, as well as its budgeted net gain for FY 2007, fell far short of prior projections and expectations.

For additional information or a copy of the full report, contact the Office of the Inspector General at (202) 633-7050 or visit http://www.si.edu/oig.

Smithsonian Institution

Date January 19, 2007

To Audit and Review Committee, Smithsonian Board of Regents

cc Lawrence M. Small, Secretary
Sheila P. Burke, Deputy Secretary and Chief Operating Officer
Gary M. Beer, Chief Executive Officer, Smithsonian Business Ventures

From A. Sprightley Ryan, Acting Inspector General

Subject Audit of Executive Compensation at Smithsonian Business Ventures, Phase I, Number A-06-02

In this audit report, the first of two on executive compensation at the Smithsonian,[1] our objectives were to assess (1) how Smithsonian Business Ventures (SBV) establishes and documents executive compensation levels, including bonuses; (2) whether actual payments are in compliance with policies and procedures; and (3) the sources and reliability of the revenues and other performance data used to calculate the salaries and bonuses. An additional objective of our audit coverage of SBV is to examine how SBV recognizes and records net revenues from its contractors, both to expand on earlier audit work[2] and to examine more closely a major source of income that affects compensation levels.

We divided our work on SBV executive compensation into two phases. Phase I primarily covered the first two objectives: how SBV establishes compensation for its executives, and whether compensation payments are in compliance with policies and procedures. This Phase I report also includes a preliminary review of the third objective. Our Phase II report will cover the third objective in more depth, as well as SBV's oversight of contractor revenues and expenses.

We present this Phase I report in three parts. In the first, we identify the amounts and types of compensation SBV executives receive, including comparisons to compensation at other organizations, and assess SBV's compensation process. In the second part, we present our initial observations on the reliability of SBV's financial data, upon which executive compensation is ultimately based. Because SBV used a pay-for-performance model for executive compensation, in the third part we look at SBV's long-term financial performance.

Appendix A provides a detailed discussion of our scope and methodology.

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[1] The second report, Number A-06-06, covers non-Smithsonian Business Ventures executive compensation at the Smithsonian. We conducted that audit because the Chairman of the Senate Committee on Finance requested we expand this audit to cover executives and senior managers throughout the Institution.

[2] *National Air and Space Museum Mall Simulators,* Report No. A-04-10 (February 25, 2005).

TABLE OF CONTENTS

RESULTS IN BRIEF

Overall, we found that SBV has established a comprehensive compensation process and that executive compensation is generally within the range of similar non-profit organizations and comparably sized commercial enterprises. However, SBV does not always follow its compensation policies and procedures. A small number of individuals we sampled received incentive awards despite not having met financial performance goals, although the total sums awarded were relatively small. Further, operational goals were sometimes vague, which made measuring performance difficult. And although financial goals were established and approved in a timely fashion, operational goals often were not. We found that while SBV management generally evaluated individual performance, it did not always provide executives with written overall performance ratings. Finally, SBV lacked a disciplined process for establishing, approving, and reconciling long-term strategic plans.

In a limited review of SBV's accounting system, we observed weaknesses, many of which SBV had identified. For example, in 2005, SBV found a longstanding out-of-balance condition between the merchandise accounts payable subsidiary ledger and the general ledger, and identified posting errors and a lack of reconciliations between the ledgers. We also observed that SBV generally was tracking and accumulating only the large out-of-period adjustments, but not assessing the cumulative impact of smaller out-of-period adjustments on net gain calculations. Because of the importance of SBV's net gain to SBV executive compensation and to the Institution's unrestricted trust funds, greater assurance is needed that SBV financial results are accurate.

Finally, we examined SBV's overall financial performance since its inception. While SBV has contributed significantly to the Institution since 2000, we found that its overall inflation-adjusted net gains have declined. In essence, the amount of money that SBV currently contributes to the Institution's unrestricted trust funds is lower, in real dollars, than the amount Smithsonian businesses contributed in 1999, before SBV began. Moreover, SBV's long-term strategic plans have been overly optimistic.

SBV's target net gain for 2007 is $25.3 million, just above its average net gain for the past 5 years as it rebounded from the aftermath of September 11, and is equivalent to about $20 million in 1999 dollars (when Smithsonian business activities netted $27.9 million[3]). Given this disappointing performance, the Institution should reexamine whether SBV's market-based compensation model has been effective and whether compensation levels are appropriate given its financial contributions to date.

In this report, we make eight recommendations to correct observed weaknesses and strengthen the compensation process at SBV.

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[3] Smithsonian business activities reported $29.2 million in net gains in 1999, but for trend analysis purposes, we have adjusted that figure to account for certain administrative costs and other factors, as we explain in footnote 18.

BACKGROUND

The Smithsonian Institution

The Smithsonian Institution is a trust instrumentality of the United States created by Congress in 1846 to carry out the provisions of the will of James Smithson, an English scientist who left his estate to the United States of America to found "an establishment for the increase and diffusion of knowledge." Although a federal entity, the Smithsonian does not exercise governmental powers or executive authority, such as enforcing the laws of Congress or administering government programs. It is essentially a non-profit institution dedicated to the advancement of learning, with an extensive museum and research complex that today includes 19 museums and galleries, the National Zoological Park, and research centers around the nation's capital, in eight states, and in the Republic of Panama. The Smithsonian Board of Regents is the governing body of the Institution. The Board appoints the Secretary, who runs the Institution's day to day operations as its chief executive officer.

Federal appropriations provide the core support for the Institution's science efforts, museum functions and infrastructure. Trust resources, including external grants and private donations, supplement those appropriations. In FY 2006, the Institution received a federal appropriation of about $615 million. Trust funding for FY 2006, which included more than $100 million in federal research grants and contracts, was estimated at $274 million.

Trust funds used by the Institution include unrestricted funds, funds restricted by the donor or sponsor, funds restricted for specific uses, and government grants and contracts. Unrestricted trust funds comprise investment income; earnings from restricted endowments; and net proceeds from SBV's operations, which include museum shops, mail order, and food service concessions; sales of Smithsonian books, records, and other products based on designs and objects in the collections; theater and planetarium operations; domestic and international travel activities; and magazine production.

Smithsonian Business Ventures

In 1998, the Smithsonian Board of Regents, recognizing that furthering the Institution's mission depends heavily on private funding, sought to consolidate the Institution's then disparate business activities to improve their management and to increase their contributions to the Institution's unrestricted funds. An outside consulting firm conducted a review of Smithsonian businesses activities and suggested that bringing them under a single, new management structure modeled on the private sector could increase income by more than 150 percent within 5 years. The consultant noted that the existing organization would not support the full achievement of these business opportunities. The Board of Regents thus authorized the Secretary of the Smithsonian to reorganize most of the business activities into the centralized Smithsonian Business Ventures, the purpose of which was to increase unrestricted trust funds by expanding existing businesses, initiating new businesses, and improving management and operational efficiency.

To lead SBV, the Board of Regents authorized the hiring of a Chief Executive Officer (CEO), with the understanding that the CEO would be recruited from the business sector and that compensation for the CEO and key managers of this new business entity would be competitive with the commercial market, even though it would be greater than compensation at other units of the Institution. The Board of Regents also authorized the establishment of a Board of Directors for SBV[4] to provide advice and recommendations to the Board of Regents, the Secretary, and SBV's CEO.

The CEO assumed SBV's top position in August 1999, but SBV did not become a fully functioning, separate unit within the Institution until FY 2000. SBV is made up of several business units: Magazines; Retail (museum stores, concessions, and theaters); Catalogue; and Product Development and Licensing. In 2005 and 2006, SBV expanded its businesses to include travel (Smithsonian Journeys), a joint publishing venture with Harper-Collins and a long-term media deal with Showtime Networks called Smithsonian on Demand. There have generally been 8 to 10 executive positions at SBV, including the CEO, and several dozen division managers. In FY 2006, SBV had a total of 480 employees (full-time equivalents), including the CEO, executives and division managers.

In FY 1999, the last full year before the businesses were consolidated under the new CEO's leadership, Smithsonian business activities generated net gains of about $27.9 million, on revenues of $156 million.[5] SBV's annual revenues since its inception have ranged from $143 million in FY 2003 to $172 million in FY 2005 (in nominal, in other words, reported, dollars).

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[4] SBV Board members receive no compensation for their services.

[5] Net gain is SBV management's financial reporting terminology and is equivalent to net income, i.e., total revenues minus total expenses.

RESULTS OF AUDIT

Overall, we found that SBV has established a comprehensive compensation process and that executive compensation is generally within the range of comparably sized commercial enterprises as well as non-profit organizations. However, SBV does not always follow its compensation policies and procedures. For example, SBV gave incentive awards even though executives and division managers did not meet approved financial performance goals. We also found that SBV lacked a disciplined process for establishing, approving, and reconciling long-term strategic plans. We observed weaknesses in SBV's accounting system that affect the reliability of the reported financial performance results upon which compensation is based. Finally, we performed an analysis of SBV's long-term financial performance and concluded that the SBV is contributing less to the Institution today, after inflation, than Smithsonian business activities contributed the year before SBV began.

I. SBV EXECUTIVE COMPENSATION

SBV embraces "pay for performance" as its compensation philosophy, based on best practices in the private sector. SBV's goal is to attract and retain superior talent, while competing with other sophisticated organizations for the best available leadership. SBV's Executive Compensation Policy states that executive compensation should (1) align the self-interest of senior executives with the goals of SBV; (2) attract and retain executives with the skills necessary to accomplish the growth goals of SBV; (3) encourage the formulation of aggressive – but achievable – financial goals in annual budgets and multi-year growth plans; (4) encourage the achievement of both annual and long-term financial and operational goals; and (5) encourage actions that will improve the long-term growth of SBV's businesses. Executives "should have an opportunity to earn substantial rewards for producing substantially increased 'Net Gain' (profit) for the Institution, and compensation should be "limited if profits are stagnant or decline from relevant prior periods."

SBV Has Established a Comprehensive Compensation Process

To implement its compensation policy, SBV has established a comprehensive process for developing individual compensation plans for executives and managers and for providing oversight of compensation decisions. To set executive compensation levels, SBV obtains advice from third-party consultants, who conduct surveys of comparable organizations in the retail and publishing industries and in the non-profit sector. Under this market-based system, SBV executives and other employees do not receive automatic cost-of-living adjustments. Instead, any increases in compensation are to be performance-based and relevant to market conditions. Thus, in addition to market-based salaries, SBV offers executives and division managers the opportunity to earn annual incentive awards for achieving financial and operational goals.[6]

Prior to FY 2004, SBV had executive incentive award plans for those individuals who reported directly to the SBV CEO. Some division managers also had formal incentive plans, and other division managers could receive annual cash awards based on performance. With the assistance of an outside consultant, in FY 2004, SBV refined the executive incentive plan and formalized and expanded the incentive plan for division managers.[7]

Generally, SBV targets the 50th percentile of the market for total cash compensation packages (base salary and target incentives). In FY 2005, annual target incentive awards ranged from 15 to 50 percent of base salaries for Executive Incentive Plan participants, and the target awards by division ranged from 7 to 13 percent of base salaries for Division Management Incentive Plan participants. SBV's Executive Compensation Policy requires that the specifics of compensation plans be "fully stated in writing no later than the beginning of the fiscal year covered by the incentive." Moreover, performance standards "should be specific and measurable with minimal reliance on discretionary awards."

SBV develops individual incentive plans each fiscal year with both financial and operational goals for eligible executives and division managers. Financial goals are primarily based on achieving division net gain and other related financial metrics established in the annual budget.[8] Individual operational goals for executives are developed through discussions with the CEO, and those for participants in the division management plan are developed through discussions with division heads with input from the CFO and Vice President of Human Resources. According to SBV policy, incentive plans should be approved by the CEO for executive participants and by the division heads for the divisional participants prior to being issued. After approval, all employees should review and sign their respective incentive plan worksheets.

Financial performance goals account for 70 percent of the incentive plan awards. SBV has set financial performance cliffs for each division, which are a percentage of the financial goal below which no incentive will be paid. These cliffs vary between 90 percent and 95 percent of the financial goal for that fiscal year. Once the cliff has been reached, a participant may be awarded between 75 percent and 160 percent of the financial target award, depending on actual financial performance.

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[6] The SBV CEO also has a long-term incentive plan.
[7] The Executive Incentive Plan covers senior executives who report directly to the CEO. The Division Management Incentive Plan covers business unit managers, direct reports to business unit managers, and other employees designated by the division head.
[8] The SBV Chief Financial Officer (CFO) and division heads develop the annual financial budget. The SBV CEO and the SBV Board of Directors review and approve the annual budget prior to the beginning of the fiscal year.

Individual operational goals account for the remaining 30 percent of the award opportunity, but operational awards may only be given if the particular division achieved 75 percent of its budgeted net gain. Generally, there are no awards for achieving less than 100 percent of individual operational goals. There are also no above-target awards (greater than 100 percent) for exceeding operational goals. Considering both financial and operational targets, executives and division managers can earn a maximum award of 142 percent of target.

At the end of the year, after SBV's fiscal year results are known and approved, actual results are entered into incentive worksheets to calculate the awards. The SBV Board of Directors' Compensation Committee reviews management's recommendations for the incentive plan awards as well as proposed changes in compensation for senior executives and for all incentive plans (including growth targets and allocation of incentives between financial and operational goals). The compensation recommendations are then submitted to the Secretary for his approval.[9] For those executives and senior division managers whose salaries exceed a defined dollar amount ($124,736 in 2005 and $129,024 in 2006), the Secretary and Board of Regents also review and approve incentives and proposed salary increases. In 2005, there were 26 SBV executives and division managers whose salaries exceeded this level; in 2006, preliminary figures indicate there will be 27.

SBV Executive Compensation is in the Range of Similar Organizations

As of January 2005, 78 SBV employees participated in incentive plans, 10 in the Executive Incentive Plan and 68 in the Division Management Incentive Plan. Average compensation, including base pay, incentives, and other bonuses, was $251,000 for Executive Plan participants and $100,000 for Division Management Plan participants. For 2005, a compensation consultant for SBV determined that the total compensation (salary plus incentives) of SBV executives was generally competitive with the 50th percentile of the market, based on surveys of comparable organizations in the retail and publishing industries as well as of non-profit organizations.[10]

For FY 2005, executive compensation per participant ranged from $136,000 to $499,000[11] (including the CEO),[12] and division manager compensation per participant

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[9] The SBV Board's Compensation Committee also provides recommendations to the Secretary concerning the performance and compensation of the CEO as well as CEO contract renewal.

[10] In a June 2005 report to the SBV Board, a separate compensation consultant concluded that the CEO's then-proposed total compensation package was reasonable in the aggregate, although his compensation in 2004 exceeded the 75th percentile of the comparable market.

[11] We note that the U.S. House Appropriations Committee's Department of Interior, Environment, and Related Agencies Appropriations Bill for fiscal year 2007 (H.R. 5386) would limit total compensation of Smithsonian officers and employees to no more than the salary of the President of the United States, currently $400,000.

[12] This report does not cover the CEO's compensation in depth. At the request of the Secretary and the Board of Regents, outside auditors (under the supervision of the Office of the Inspector General) conducted an agreed-upon procedures review of his compensation and expenses.

ranged from $43,000 to $249,000. Appendix B sets forth the compensation of all participants in SBV's Executive Incentive Plan for FYs 2000 through 2006.

For comparison, we judgmentally selected a sample of thirty organizations comprising non-profits with somewhat similar executive positions as well as publicly traded companies within SBV's general revenue range. Appendix C (Tables 1 and 2) lists the sampled organizations and companies. The range of pay for executives at these organizations was fairly broad, and SBV executive compensation fell within this general range. For example, we compared the SBV CEO's compensation to that of CEOs of non-profit organizations with missions similar to those of the Institution and found several, such as the Wildlife Conservation Society and the Harvard Business School Publishing Corporation, whose total compensation exceeded that of SBV's CEO. See Table 1 below for a sample of CEO comparisons.

Table 1. 2005 CEO Compensation at Selected Non-Profit Organizations*

Organization	Revenues (in Millions)	Title	Compensation	Other Allowances	Total
Harvard Business School Publishing Corporation	$93	President & CEO	$788,380	0	$788,380
Wildlife Conservation Society	196	President & CEO	455,180	139,400	594,580
Smithsonian Business Ventures	172	CEO	570,317**	0	570,317
National Gallery of Art	154***	Director	456,444	49,908	506,352
The United States Holocaust Memorial Museum	85	Museum Director	387,689	362	388,051
World Wildlife Fund	121	President & Director	339,752	0	339,752

*Data obtained from organizations' IRS 990 forms. "Contributions to Employee Benefit Plans and Deferred Compensation" from the 990 form is not included. "Compensation" includes base salary and bonuses. "Other allowances" includes expense accounts and fringe benefits such as housing and car allowances. Form 990 compensation is prepared on a "cash" basis when compensation is included in the year received, so SBV's CEO compensation in this table is different than elsewhere in the report where compensation is included in the year earned (accrual basis), not the year received.

**According to the Office of the Comptroller, SBV's CEO compensation in 2005 was inadvertently miscalculated for the 990; 27 pay periods were reported instead of 26. The CEO's actual 2005 cash compensation was $558,075 (base pay of $350,000 and 2004 incentive award of $208,075).

*** National Gallery of Art revenues are for 2004.

We also judgmentally selected a sample of Securities and Exchange Commission filings of publicly traded companies with annual revenues of $150 million to $200 million and found that the SBV CEO's compensation falls within the range of their executives. See Table 2 below for a sample of CEO comparisons.

Table 2. 2005 CEO Compensation at Publicly Traded Companies with Similar Revenues*

Company	Revenues ($ in Millions)	Title	Salary	Bonus	"Other"	Total
Caribou Coffee Company, Inc.	$198	CEO, President & Chairman of the Board	$442,308	$250,000	$750,000 (signing bonus)	$1,442,308
Alloy, Inc.	195	CEO	420,000	300,000	0	720,000
Penton Media, Inc.	193	CEO	425,000	175,855	83,500 (long-term incentive payment)	684,355
Big Dog Holdings, Inc.	179	President & CEO	385,071	160,000	0	545,071
Smithsonian Business Ventures	172	CEO	350,000	149,240	0	499,240
The Coast Distribution System, Inc.	176	Chairman & CEO	263,042	108,000	0	371,042
Max & Erma's Restaurants, Inc.	184	Chairman & CEO	356,539	0	0	356,539

*Note: Non-SBV data is from SEC filings. SBV data was provided by SBV's Office of Human Resources. Compensation for Table 2 was for the year earned, not the year received, so compensation for SBV's CEO in Table 1 is different from his compensation in Table 2. Note also that this table does not include total benefits or stock options.

For SBV executives other than the CEO, we compared SBV compensation packages to compensation packages at publicly traded companies with annual revenues between $150 million and $200 million as well as to non-profit organizations with somewhat similar positions. Our analysis was limited by the information available on non-profit IRS 990 filings and publicly traded company SEC filings. For example, the filings do not provide detailed position responsibilities. Additionally, our analysis was limited by the individual characteristics of each organization and position. Position titles and responsibilities differ from organization to organization, so we selected positions with similar titles to improve comparability to the extent practicable. Table 3 on the next page shows the top five SBV non-CEO executives based on total compensation for FY 2005. See Appendix D (Tables 1 and 2) for a selection of similar positions that we sampled from non-profit organizations and publicly-traded companies. Overall, compensation for the participants in SBV's Executive Incentive Plan was within the range of compensation packages provided at the other organizations we sampled.

Table 3. Top Five Non-CEO SBV Executives Based on Total Compensation for FY 2005*

Title	Base Pay	Incentives	Total
Executive VP, Member Services	$235,000	$97,447	$332,447
Editor-in-Chief	257,000	58,984	315,984
COO, Museum Operations	200,000	71,279	271,279
Publisher	266,475	0	266,475
CFO	185,000	51,807	236,807

* Data provided by SBV's Office of Human Resources. In FY 2006, SBV recruited two new executives who replaced the COO for museum operations and the publisher. Compensation packages for each exceeded $400,000. The figures above do not match those in Appendix B because this analysis is based on a full-year base salary.

SBV's Implementation of its Compensation Policy Needs Improvement

SBV has established comprehensive compensation policies and procedures for executives and division managers. We also found that executive and senior manager incentive awards as a percent of net gain fluctuated between one and two percent over the 7-year period from 2000 through 2006, resulting in little change in the relationship of incentive awards to net gain. (See Table 9 in Appendix E.) However, we identified several deficiencies in the implementation of SBV's incentive plans. In some instances, individuals received incentive awards despite not meeting required financial performance goals. Operational goals were sometimes vague, which made measuring performance difficult, and approval of those goals was often not timely. While we found that SBV management generally evaluated employee performance, we also found that management did not always provide Executive Plan participants with written overall performance ratings. Finally, SBV lacked a disciplined process for establishing, approving, and reconciling long-term strategic plans.

SBV Gave Incentive Awards Despite Failure to Meet Financial Performance Goals

According to SBV policy for both the SBV Executive and Division Management Incentive Plans, awards should not be paid for financial performance below the financial threshold level. Thus, for example, to receive an award for a particular financial performance measure, Retail, Magazine, and Corporate plan participants must meet 95 percent of their financial goals, and Catalog and Product Development and Licensing plan participants must meet 90 percent of their financial goals.

SBV paid over $1.3 million in incentive awards associated with financial measures to executives and division managers in FYs 2004 and 2005. We reviewed nearly three-quarters of the incentive plan participants, accounting for about 90 percent of the incentive payments. We found that SBV management approved exceptions for several individuals totaling about $32,000, a small percentage of our sample, paying incentive bonuses that were not based on the actual financial performance. Specifically, we found that SBV awarded:

- $20,927 to Product Development and Licensing managers for FY 2005 despite failure to attain business unit net contribution financial goals.
- $5,672 to Theater managers for FY 2004 despite failure to attain Theater net gain performance goals.
- $3,862 to corporate accounting managers for FY 2005 despite failure to attain the accounting net contribution financial goal.
- $1,357 to corporate communications managers for FY 2005 despite failure to meet the communications net financial goal.

In interviews, SBV management indicated that they made exceptions for several reasons. In most cases, the awards were either intended to offset the impact of one-time costs that were outside the divisions' control or reflected the write-off of a film that was not performing well. However, SBV could not provide contemporaneous documentation of their justifications for granting the awards.

SBV's Incentive Plan Operational Goals Were Not Approved Timely and Were Often Too Vague for Objective Measurement

Good business practice, as expressed in SBV's Compensation Policy, requires that incentive goals be established at the outset of the fiscal year, and that they be clear and measurable. We examined a judgmental sample of more than one-fourth of the eligible participants[13] in the incentive plans who, combined, were paid over $340,000 in incentive payments associated with operational goals in FYs 2004 and 2005. We found that SBV often did not approve operational goals in a timely fashion and set goals that were too vague to allow objective measurement of performance.

SBV Often Did Not Document Approval of Operational Goals On a Timely Basis

Although SBV management was consistently establishing incentive plan *financial* goals at the beginning of the fiscal year, in many instances, we found SBV had not approved the *operational* goals in writing until the middle of the fiscal year or later. For example, in our sample of FY 2004 incentive worksheets, we found 25 percent were dated halfway through the fiscal year and many of the remainder were not dated. In our FY 2005 sample, we found 11 percent were dated mid-year. Also, we found two FY 2006

[13] Our sample comprised 20 participants in FY 2004 and 19 in FY 2005.

incentive plans that were not signed until August, one month short of the end of the fiscal year performance period.

In our view, this condition was caused by a combination of a lack of SBV management oversight and an environment where the timely setting and approval of incentive plan operational goals are not as high a priority as setting and approving financial goals. Without written evidence that management has approved operational goals early in the fiscal year, employees may not be motivated to focus their efforts on management's priority areas, such as those that may have the greatest impact on net gain. Moreover, without timely written approvals, management may find it more difficult to hold incentive plan participants properly accountable for results.

Operational Goals Were Often Too Vague To Measure

Senior SBV management established operational goals that in some instances were imprecise, contrary to SBV's policy that they be clear and measurable. For example, there were goals expressed as "sales per visitor" or "payroll management" or "organizational productivity," without any target amounts linked to them. We found that approximately one half of the operational goals for FYs 2004 and 2005 in our sample were similarly vague.

A lack of clear and measurable operational goals makes it difficult to measure performance objectively and thus to hold individuals accountable for their performance. For example, instead of saying "sales per visitor," performance could be measured against the goals more easily if the goals were worded more precisely, such as "increase sales per visitor from (amount X) to (an increased amount Y)." Considering that 30 percent of annual incentive bonuses are based on achieving operational goals, this area needs management attention.

In our discussions with SBV, management recognized the shortcomings in its implementation of the operational goals portion of the incentive award system. They indicated that they are working to improve the clarity of individual operational goals and to finalize those goals earlier in the fiscal year.

Many Incentive Plan Participants Lacked Documentation of Overall Performance Appraisal Ratings

According to SBV's Office of Human Resources, SBV is supposed to follow the Institution's policies requiring annual performance appraisals. Although we saw evidence that management evaluated employee performance, we found that 25 percent and 63 percent, respectively, of the executives and division managers in our samples for 2004 and 2005 lacked a written performance appraisal summary rating. In FY 2004, four of the seven employees in our sample who did not have a written performance appraisal summary rating received an award; for FY 2005, all 12 of the employees who lacked performance appraisal summary ratings received incentive awards. We noted that starting in FY 2006, SBV issued instructions indicating that employees must have an annual appraisal and receive a rating of at least fully successful to qualify for an incentive award.

Where managers fail to assign performance evaluation ratings, individuals do not receive important written feedback on their performance, and it becomes difficult to make meaningful distinctions in levels of performance. In addition, the lack of documentation may make it difficult to hold managers fully accountable for the performance of their divisions in meeting annual and long-term strategic goals.

SBV Lacked a Disciplined Process for Establishing, Approving, and Reconciling Long-Term Strategic Plans

SBV lacked a disciplined process for establishing and approving long-term strategic plans, and for reconciling approved long-term goals with actual annual results. Aligning employee performance goals with an organization's strategic goals is a best practice both in industry and in the government, and indeed at the Smithsonian. According to the President's Management Agenda, organizations should implement a human capital plan that is integrated with the organization's overall strategic plan and with its annual performance goals; analyze the results of the plan; and use those results to improve both the plans and employee performance.

In developing annual budgets, SBV has compared them to prior year performance and identified factors affecting the upcoming budget year. In its annual September budget presentations to the SBV Board, SBV presents detailed analyses of the previous year's actual net gain compared to the previous year's budget; calculates percentage variances; identifies factors such as visitation levels or trends in advertising revenue that contribute to the variances; identifies key drivers of net gain for the upcoming year by division; and gives quantitative analyses comparing that with the previous year's actual net gain. According to the CEO, the annual budgets provide spending for immediate, short-term needs and business activities as well as longer-term initiatives. We also note that the SBV Board holds annual retreats to focus on current and new business initiatives as well as strategic issues. For instance, at the Summer 2006 retreat, discussions centered on high-level goals and initiatives that will have the greatest impact on line-of-business performance over the next 3 years.

What we found missing was both a disciplined process for the development, review, and approval of long-term strategic plans and a mechanism for reconciling annual budgets and actual financial results to those plans. The most recent budget cycle is a good example. As part of the FY 2007 annual budget process, SBV's divisions prepared detailed preliminary long-term plan forecasts for 2007 through 2009. Elements of these preliminary plans were shared with the SBV Board as part of the budget discussions. However, these divisional forecasts were not formally endorsed by the SBV Board or approved by the Secretary. Nor was a consolidated 3- to 5-year long-term plan forecast prepared or approved before the 2007 budget was finalized.

We also did not see any reconciliation or analysis that compared the 2007 budgeted net gain of $25.3 million to prior long-term forecasts. For instance, in January 2005, SBV submitted a long-term plan outlook to the SBV Board that projected a net gain in 2007 of $36 million. In June 2005, SBV presented its 2010 outlook report to the Board of Regents that included a 2007 net gain forecast of $35 million. A comprehensive reconciliation of budgeted net gain, actual results and previous long-range projections would provide the Secretary and Board of Regents important information to guide decisions on future initiatives, improve long-range forecasts, evaluate existing strategies, and provide a better means for holding SBV executives accountable for achieving long-term financial goals.

Financial goals aside, we also observed that operational goals in annual incentive plans were not clearly linked to growth strategies in long-term strategic plans. For example, in the most recent preliminary long-term plan covering the period through 2009 for the the Stores, operational goals such as customer service initiatives, holiday promotions, and cherry blossom promotions were listed. However, the FY 2006 retail division managers' incentive compensation worksheets listed goals such as "reduce sku count[14] by 10 percent from beginning of year levels" and "implement procedures to reduce damage percentage." While accomplishing these operational goals would appear to benefit SBV's bottom-line financial performance, we saw no documented link to the stated retail division operational goals. Moreover, in FY 2006, 10 out of 57 participants in the incentive compensation plan received operational awards totaling approximately $51,000 even though they did not attain their financial goals. Employees' efforts to increase SBV's long-term net gain might be more successful if SBV could more carefully demonstrate how operational goals promote long-term financial performance.

In our view, strengthening the process for establishing and approving long-term strategic plans and comparing them to annual budgets and actual performance would enhance visibility and accountability for achieving long-term net gain growth.

[14] A "sku" is a stock-keeping unit used by merchants to permit systematic tracking of products.

RECOMMENDATIONS

We recommend that the SBV CEO ensure that:

1. Any payments of incentive bonuses based on exceptions from approved financial and operational goals are justified and documented in writing at the time of the award.

2. Managers establish operational goals at the beginning of the fiscal year and that incentive plan worksheets are properly documented with supervisor and employee signatures and dates.

3. Operational goals are specific and measurable and can be clearly linked to improved organizational results.

4. Managers approve performance plans at the beginning of each year and complete written summary performance appraisals for all individuals promptly at year's end.

5. SBV develops a 3- to 5-year strategic plan for approval by the SBV Board of Directors and the Secretary. Annual financial targets and actual performance should be reconciled to approved long-term plan goals and considered when making compensation decisions. Measurable operational goals that are long-term drivers of net gain should be more closely linked to growth strategies in approved long-term strategic plans.

II. OBSERVATIONS ON SBV'S ACCOUNTING SYSTEM

Although SBV is a separate unit of the Smithsonian and operates its own financial and human resources systems, it is not a separate entity. Accordingly, SBV is not audited separately but instead is included in the annual audit of the Smithsonian's financial statements. Nonetheless, because of materiality thresholds,[15] the external auditors perform less detailed control reviews and less testing of SBV revenues and expenses than would be performed if SBV had a separate, stand-alone audit.[16]

Smithsonian Directive 115, *Management Controls,* states that transactions should be promptly recorded, properly classified, and accounted for to prepare timely accounts and reliable financial and other reports. Generally accepted accounting principles provide the framework for proper accounting and financial reporting practices. With these criteria as our guide, we offer the following observations based on our initial work. As part of Phase II of our audit coverage on executive compensation, we will be looking in more depth at the reliability of the data on which compensation decisions are made.

Control Weaknesses in Retail Merchandise and Accounting System

Prior to June 2005, SBV's business units had independent accounting operations which recorded business activity into SBV's general ledger system with limited central review. At the close of 2005, after centralizing the accounting functions, SBV accounting management identified a longstanding out-of-balance condition between the merchandise accounts payable subsidiary ledger and the general ledger. SBV's review found problems with posting errors, inadequately trained personnel, and a lack of reconciliations between the ledgers.

Consequently, for FY 2005, SBV recorded a $684,000 liability adjustment (an increase) to reconcile the accounts payable subsidiary ledger and the general ledger, which increased FY 2005 expenses. The SBV CFO indicated he informed management that further adjustments would likely be required in FY 2006, subject to the results of a third-party system review ordered by SBV management. As a result of that review, the consultant identified control weaknesses such as a general lack of understanding of the

[15] Materiality is defined by the Financial Accounting Standards Board, one of the accounting industry's rulemaking bodies, as the magnitude of an omission or misstatement in the financial statements that makes it probable that a reasonable person relying on those financial statements would have been influenced by the omitted information or made a different judgment if the correct information had been known.

[16] SBV engaged external auditors to conduct a *review* of SBV's financial statements in 2003 and 2004. A review consists principally of inquiries of SBV personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. In a review, the auditor does not express an opinion on the financial statements. A review is made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with generally accepted accounting principles.

system, a lack of documented procedures, and a need for accounting system upgrades. Moreover, in light of the weaknesses identified in the retail merchandise and accounting system, the SBV CFO did not sign the management representation letter for the FY 2004 independent auditor's review of SBV's financial statements, and the review report was not issued.

SBV has initiated corrective action, including documenting accounts payable procedures and providing system training for accounts payable staff. Working with the consultant, SBV adjusted the general ledger and the accounts payable subsidiary ledger. In FY 2006, SBV recorded an additional adjustment (a decrease) to accounts payable of approximately $1.1 million, which decreased cost of goods sold and increased net gain.

SBV's CFO advised us that it will be a multi-year project (through summer 2007) to complete the review of the merchandise and accounting system and make needed system improvements, such as developing an automatic interface between the accounts payable subsidiary ledger and the general ledger. They have begun work on the second phase of the project, which will focus on how merchandise is procured and accounted for and how purchase orders are generated. SBV also has identified a need to establish a compliance component within its accounting department to ensure consistent application of SBV accounting policies and practices. However, this position was not budgeted for in FY 2007.

Out-of-Period Accounting Adjustments and Errors That Affect Net Gain Need to be Tracked

We performed a limited review of SBV's general ledger to look for unusual account activity that would affect the annual calculation of net gain, the primary financial goal supporting bonuses in SBV's executive and division manager incentive plans. We noted numerous accounting errors and corrections. While errors typically occur in the normal course of an accounting cycle, we observed that some involved large dollar amounts. We also observed that SBV was not accumulating smaller, but significant, out-of-period adjustments and that SBV was not assessing their cumulative impact on net gain calculations. The SBV CFO generally agreed that smaller items were not being tracked but stated that the largest out-of-period items were being captured.

We could not retroactively determine the full effect on net gain over the last several years because of the sheer volume of accounting transactions and the various labels SBV associated with the adjusting entries. However, we noted a number of transactions that could have significantly affected reported net gain. For example, an entry for $100,000 was recorded in FY 2005 that reduced concessions revenue and was made to reverse a duplicate posting in FY 2004 (net gain was overstated in FY 2004 and understated in FY 2005). An entry in FY 2003 was recorded to increase inventory by $70,000 for a transfer of goods from the catalogue to an outlet store, and a corresponding entry was posted to decrease the cost of goods sold account. This entry was reversed in 2004. As a result, net gain was overstated in FY 2003 and understated in FY 2004 by $70,000. Income statement accounts should not have been involved; only inventory-related accounts should have been affected. In FY 2002, SBV over-recognized about $292,000 in revenue from a sponsorship agreement because it incorrectly recorded an entire year's revenue when only 5 months' worth of revenue was earned. The error was not fully corrected for 3 years, and then it was reversed against an equity account, contrary to SBV's normal operating practice of posting out-of-period adjustments to current income. We will examine this issue more fully in Phase II of this audit.

According to SBV management, they did not closely track or accumulate prior-year adjustment activity because the Institution's external auditors had advised them to post adjustments to current income for purposes of preparing Smithsonian-wide financial statements. We agree with this accounting treatment given the materiality threshold for recording prior-year adjustments for the Institution as a whole. In other words, SBV prior-year adjustments to income would not normally be large enough to materially affect the financial statements of the entire Institution.

However, a much lower materiality threshold should be established for SBV's financial statements because of the risk of material misstatements to SBV's net gain results and the internal uses of its reported financial data. For SBV, overall reported net gain, as well as division net gain, are primary factors upon which annual incentive bonuses are paid to executives and division managers. According to a widely used accounting industry reference, *Interpretations and Application of Generally Accepted Accounting Principles by Wiley*, 2006 GAAP edition, "a transaction that allows management to achieve a target or obtain a bonus would be considered material, regardless of the actual amount involved."[17] Further, SBV net gain is the largest single source of unrestricted funds for the Institution and, thus, is important for furthering mission objectives. Because of the control weaknesses and the accounting adjustments noted, as well as the importance of net gain to the Institution, we believe that greater assurances are needed to ensure that SBV financial results are accurate and reliable.

[17] According to the Security and Exchange Commission's Staff Accounting Bulletin No. 99, "in a financial statement, a quantitatively small misstatement may become material if the misstatement has the effect of increasing management's compensation- for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation."

RECOMMENDATIONS

We recommend that the SBV CEO ensure that:

6. All out-of-period adjustments as well as unusual and nonrecurring items are tracked and accumulated for internal management purposes; and

7. An annual examination-level attestation engagement by an independent public accountant is performed on SBV's net gain and other key financial measures to ensure that SBV's reported financial results are complete, accurate, and reliable for calculating annual incentive awards as well as for other Institution uses.

III. SBV'S FINANCIAL PERFORMANCE

While conducting this audit, we concluded that we needed to examine the overall financial performance of SBV. A number of considerations prompted us to do so. The Institution and SBV believe that market-based, private-sector compensation at SBV is necessary to ensure that SBV is successfully entrepreneurial. SBV's compensation policy explicitly ties compensation to SBV's performance. Moreover, SBV's performance – how much net gain it generates – is critical to the Institution's unrestricted Trust resources, resources essential to supporting the Smithsonian mission.

For our analysis, we relied on information provided by SBV and other units within the Institution. We drew revenue, net gain, and other financial figures from SBV's operating statements for 2001 through 2006, from reports to its Board of Directors, and from the Smithsonian's Unrestricted Funds Operating Statements for FYs 1999 and 2000. To adjust the figures to account for inflation, we used annual inflation rates for each year based on the Consumer Price Index – All Consumers, with 1999 as the base year. We chose 1999 as the base year for our analysis because it was the last full year before the various business activities were consolidated.

What we found was that while SBV had contributed significantly to the Institution over the years, its overall inflation-adjusted net gains have declined. In essence, the amount of money that SBV currently contributes (net gain) to the Institution's unrestricted trust funds is lower, in real dollars, than the amount Smithsonian businesses contributed in 1999. In summary, we observed that:

- Nominal (reported) revenues were $156 million in 1999, peaked in 2005 at $172 million, and were $164 million in 2006. Management attributes part of the drop from 2005 to 2006 to a decline in Smithsonian visitors. (See Table 6 in Appendix E for visitor levels during the period 1999 through 2006.) Adjusted for inflation, 2006 revenues were 13 percent lower than those generated in 1999. Chart 1 shows the long-term trends in SBV revenues both in nominal and inflation-adjusted dollars.

- Nominal net gains, excluding a major extraordinary item in 2005, were $27.9 million in 1999, peaked in 2005 at $30.0 million, and were $23.9 million in 2006.[18] Adjusted for inflation, the 2006 net gain was $19.8 million, a 29 percent drop from 1999. We noted that SBV's inflation-adjusted net gain for 2005, its best year to date, was 8 percent lower than 1999 results. Chart 2 shows the historical trend in SBV net gains both in nominal and inflation-adjusted dollars. Both Charts 1 and 2 show that these measures did not keep pace with inflation. In other words, SBV's earnings, purchasing power, and bottom line have eroded over the years.

[18] SBV net gain figures for 1999 through 2006 exclude SI Allocation of Administration Fees. The assessed administration fees for SBV ranged from $4.6 million in 1999 to $8.1 million in 2006. The purpose of these fees is to recover the costs associated with providing administrative support to Smithsonian auxiliary

Chart 1: SBV Nominal vs. Inflation-Adjusted Revenues
(in Millions)

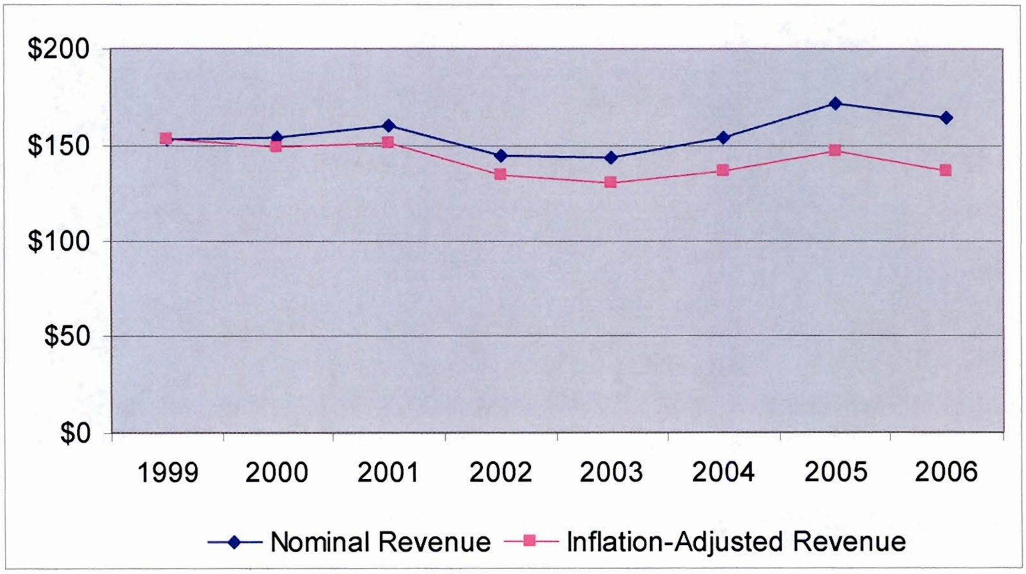
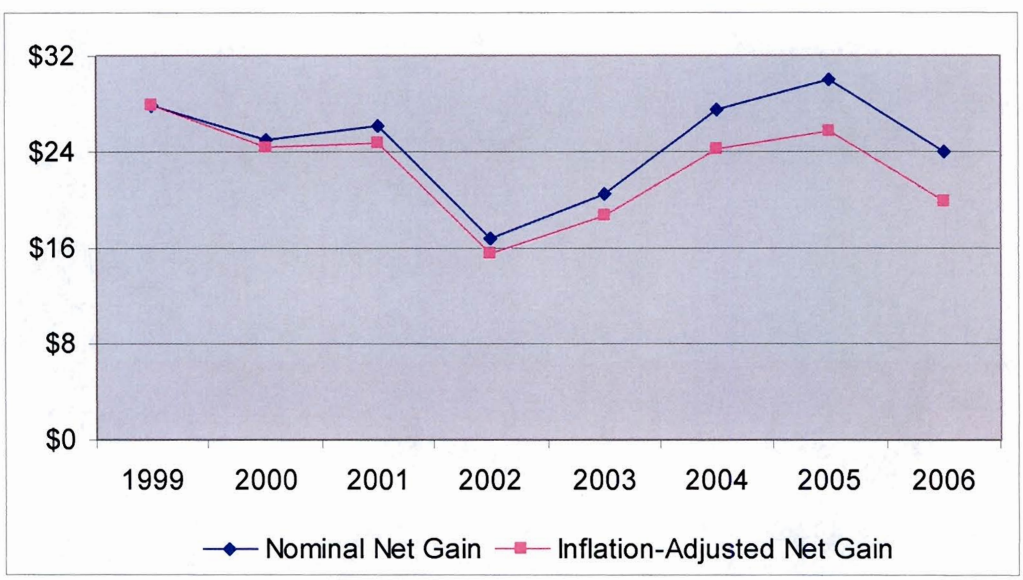


Chart 2: SBV Nominal vs. Inflation-Adjusted Net Gain
(in Millions)



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activities and other trust funds, such as accounting services, human resources, legal services, Office of the Secretary, etc. However, for comparability in our financial trend analysis, we reduced the reported 1999 net gain of $29.2 million by $1.75 million to attempt to reflect costs such as those for accounting, human resources, and information technology services provided to SBV businesses by SI central administrative offices. Beginning in 2000, SBV established these functions and began to incur its own costs.

- While SBV net gain declined in real terms, total executive compensation as a percentage of net gain grew modestly from 8 percent to 11 percent over the period. Appendix E includes additional financial ratios and analyses.

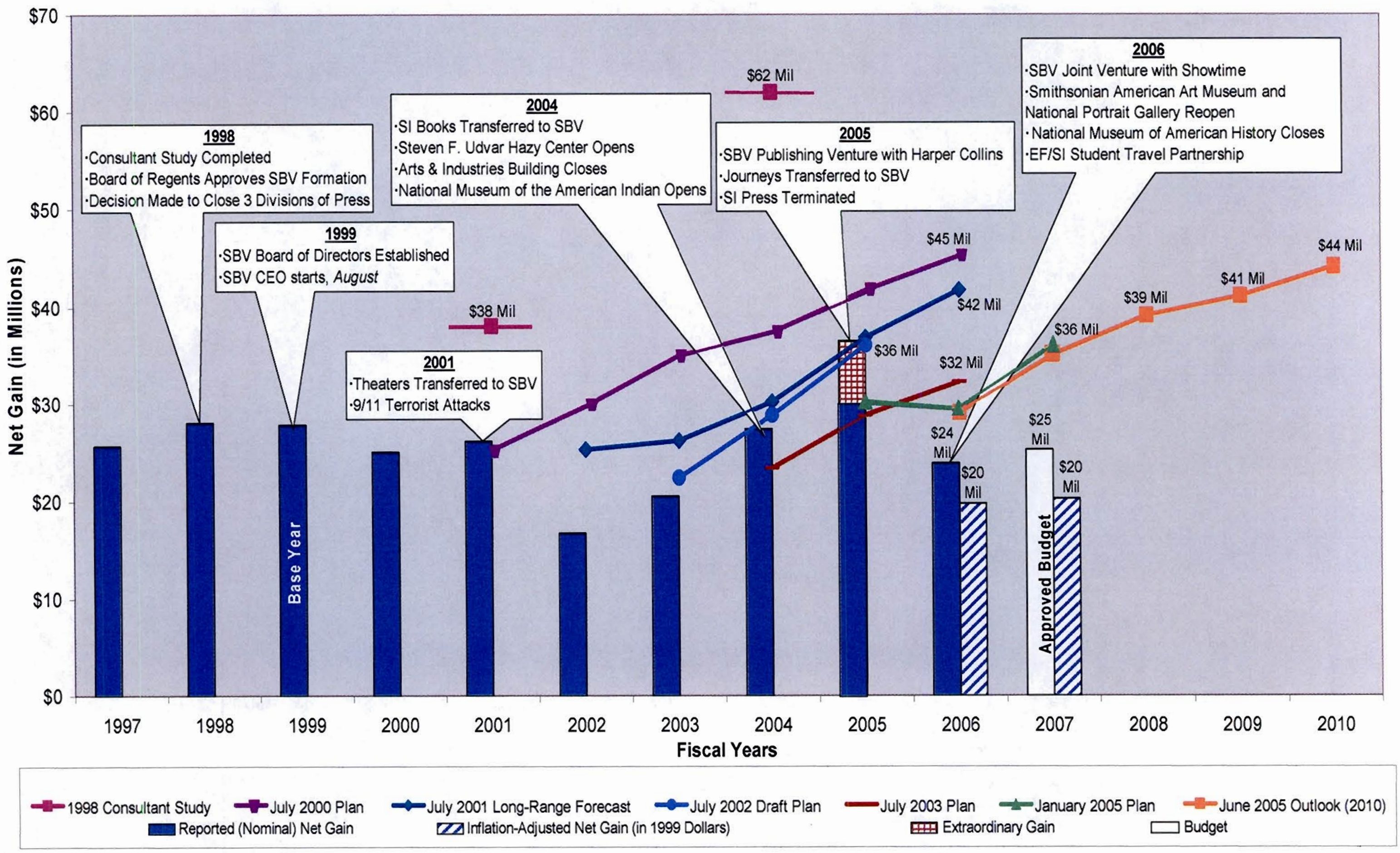
- SBV's long-term strategic plans and other long-range projections, with few exceptions, were overly optimistic. SBV's first strategic plan, developed in July 2000 for the period 2001 through 2006, projected a minimum 10 percent compound annual growth rate in net gain, reaching $45 million in 2006. During this period, a number of external factors beyond its control, including the September 11, 2001, terrorist attacks and a recession in the magazine advertising industry, had a significant negative impact on SBV revenues and net gain.

    - Nevertheless, post-September 11 strategic plans and long-range forecasts remained similarly optimistic, projecting annual growth rates of 8 to 11 percent. For example, in a long-range planning session held with the Smithsonian Board of Regents in June 2005, the SBV CEO forecasted an annual growth rate of about 8 percent over the following 5 years (2006 to 2010), culminating in a net gain of $44 million in 2010.

    - Chart 3 on the next page presents in graphic form a timeline of SBV, comparing its reported net gain over the years (in nominal rather than inflation-adjusted dollars) to its strategic plan projections, along with an overlay of significant Institution-wide events. The chart illustrates how SBV's actual performance, with few exceptions, fell short of its strategic plan forecasts.

Chart 3

Comparison of SBV Nominal Net Gains to Strategic Plan and Other Long-Term Projections*



*(Net Gain Excludes SI Allocation of Administrative Fees and 2005 Extraordinary Gain Due to Affinity Card Termination)

- Regarding the chart above, in addition to the $30 million net gain from operations for FY 2005, SBV had an extraordinary gain of $6.5 million, reflecting the early termination of an affinity credit card arrangement. If the affinity card had not been terminated, SBV estimated that net gain in FYs 2006 through 2009 would have been higher by $1.5 million to $2.0 million per year.

- SBV has recently expanded its businesses to include travel (Smithsonian Journeys), a long-term media deal (the joint venture with Showtime Networks called Smithsonian on Demand), books (the joint venture with Harper-Collins), and student travel (EF/SI Student Travel Partnership). The value of future minimum guaranteed payments for businesses such as Smithsonian on Demand and EF/SI Student Travel Partnership is not reflected in this chart beyond 2007.

- SBV has invested over $40 million in capital projects since 1999. SBV opened retail shops at three new museums (Udvar-Hazy, National Museum of the American Indian, and the Donald W. Reynolds Center), a third IMAX theater, and expanded its retail store presence at airports.

- After a disappointing performance in 2006, according to SBV's approved budget, prospects for 2007 are not significantly better. SBV's target net gain for 2007 is $25.3 million, just slightly above its average net gain for the past 5 years when SBV suffered and subsequently rebounded from the aftermath of September 11, and is equivalent to about $20 million in 1999 dollars – when Smithsonian business activities netted an adjusted $27.9 million. SBV has not provided approved detailed projections for 2008 or beyond. Regarding its high-level forecast of net gain for 2010 of $44 million, made to the Board of Regents in 2005, management has acknowledged to us that it will fall short of those projections.

We note that a fundamental tenet of SBV's compensation policy is that executive compensation be performance-driven, that there be clear consequences for underperformance, and that compensation should be limited if profits are stagnant or decline. SBV's net gain has not kept pace with inflation. Yet, total SBV executive compensation has actually increased modestly as a percentage of net gain. It appears that the current model of a mix of high (and growing) base salaries as well as annual incentive bonuses for executives and managers may not have provided the most effective long-term motivation, nor does it seem to reflect substantial consequences for SBV's financial results to date.

When SBV was formed, its key stakeholders held high expectations. SBV's own strategic plans and long-range forecasts aimed for lofty financial targets as well. As noted, external events such as the 9/11 terrorist attacks and the industry-wide downturn in magazine advertising have damaged SBV's bottom line. But even revised expectations have not been met. In our opinion, given that SBV has not achieved net gain growth as hoped, the Institution should reexamine whether SBV has the ability to produce the financial results its originators envisioned and whether its market-based compensation model as implemented is therefore appropriate.

RECOMMENDATION

We recommend that the Secretary:

8. Re-examine whether market-based compensation is the appropriate strategy for SBV and, if so, whether the level and types of executive compensation provide the most effective incentives to achieve long-term net gain growth.

MANAGEMENT RESPONSE

In SBV's January 17, 2007, response to our draft report, the CEO generally agreed with the report's findings and recommendations related to SBV's compensation process and accounting system. SBV will continue ongoing work to improve systems or develop and implement new procedures designed to address the specific recommendations. Regarding our observations on SBV's financial performance, SBV believes our financial analysis was not thorough enough because it did not fully factor in variables such as market conditions and management's actions to address them, appropriate timeframes, and long-term value creation activities. While our recommendation to re-examine how market-based compensation is implemented in SBV was addressed to the Secretary, SBV management would encourage a review of executive compensation, even though it disagreed that our audit findings warrant such an examination.

More specifically, SBV management concurred with the five recommendations to improve the implementation of SBV's compensation process. SBV will issue updated guidelines for incentive plan administration in late FY 2007, including a checklist that includes deadlines for submission of required performance documents for the completed fiscal year as well as the next fiscal year. Beginning with FY 2008, SBV will develop 3-year long-term plans with its annual budget submission to the SBV Board and the Secretary. The Compensation Committee of the SBV Board will annually review the long-term financial goals drawn from the plans along with recommendations for executive compensation and incentive plan targets.

SBV concurred with our two recommendations addressing weaknesses identified in its accounting system. SBV's Controller will be instructed to provide quarterly updates on all financial metrics that may be material to the calculation of annual incentive plan payouts for FY 2007 and beyond. SBV management also supports the recommendation to supplement the Institution's annual audit with a more detailed review of SBV's key net gain metrics. SBV's CFO will work with the Institution's CFO and external auditors to ensure appropriate actions are taken.

In her January 12, 2007, response to our recommendation to re-examine executive compensation at SBV, the Deputy Secretary and Chief Operating Officer disagreed that a wholesale review of SBV compensation is necessary. She noted that the Smithsonian magazine, travel, and publishing activities have done well for the Institution and that these business lines have been offering market-based compensation for many years. On the other hand, she agreed that SBV's approach to compensation related to its museum retail activities warrants reevaluation. Management plans to complete a review in time to present the results to the SBV Board as well as the Regent's Compensation and Human Resources Committee at their spring meetings. Appropriate changes will be implemented in FY 2008.

We have attached the full text of both management responses as Appendix F.

OFFICE OF THE INSPECTOR GENERAL COMMENTS

SBV management's proposed actions are generally responsive to the seven recommendations addressing its compensation policies and procedures and the accounting system weaknesses, and we consider them resolved. On recommendation seven, we will work closely with the Institution's CFO and SBV management in timing the engagement and in selecting and monitoring the work of the external auditors in their reliability review of SBV's key financial measures. On recommendation eight, although the Deputy Secretary's response does not cover all of SBV, it generally meets the intent of the recommendation and we consider it resolved as well.

SBV's response took issue with our observations on its financial performance, citing certain factual inconsistencies in our analysis as well as in our methodology. Based on the response, we re-examined our trend analyses and revised the numbers to reflect SBV's comments to the extent appropriate.

We also offer the following comments on certain points in SBV's response.

SBV indicated that our FY 2005 revenue and net gain figures were understated by $6.5 million because they exclude the MBNA affinity card termination payment, and SBV asserted that SBV consistently included extraordinary items in other periods. We excluded the MBNA termination payment from our trend analyses because: (1) the payment was not the result of core business activity but rather was a one-time payment for early termination of the affinity card; (2) the termination payment was not recognized by the SBV Compensation Committee for the calculation of executive incentive awards for FY 2005; and (3) SBV has inconsistently applied accounting principles for unusual, extraordinary, or non-recurring events in its financial operating statements and consequently, in our opinion, may have inconsistently recognized them for compensation purposes. We also note that the termination payment does not offset the disappointing financial results for 2006 and approved budget for 2007.

SBV questions our premising our analysis of SBV's financial performance on an estimate of net gain in FY 1999, the year before SBV management was installed and for which reliable financial statements are not available. We chose FY 1999 as the most appropriate base year for comparison precisely because it was the last full year before the CEO assumed the SBV leadership role and the SBV business activities were consolidated into a separate unit. In our view, using FY 2000 as the base year would be comparing SBV to itself after it had incurred considerable stand-alone infrastructure expenses and incorporated them in the FY 2000 financial results and, thus, would skew an analysis of SBV's bottom-line performance.

SBV further noted that we compared the FY 1999 financial results to net gain figures for other years that were from audited financial statements prepared in accordance with

GAAP. We agree the 1999 figures are not perfect. However, the FY 1999 business activity numbers essentially were subject to similar audit tests by the Institution's external auditors as SBV's numbers in subsequent years. As discussed in the report, SBV's financial data is included as part of the annual audit of the Institution's overall financial statements. Contrary to SBV's assertion in its response, SBV's financial statements are not audited separately, and based on our limited survey, the data should be viewed with some caution. Our trend analysis used the FY 1999 figures that were generally accepted at the time as the best numbers available and were reported to the Smithsonian Board of Regents. Further, we adjusted reported net gain figures to make them as comparable as practicable with subsequent years (see footnote 18).

SBV believes that the FY 1999-2006 period is a simplistic eight-year point-to-point analysis that reasonably could be changed to demonstrate a different outcome. SBV further states that the conclusions drawn from our analysis do not take into account external impacts to the business operations, both positive and negative. As discussed in the report, our observations on SBV's overall financial performance were more at a summary level, focusing on overall revenues and bottom-line performance for the period. Our report does mention external events (such as 9/11) that affected SBV's business operations but does not attempt to isolate and calculate the corresponding financial impacts. We would welcome an opportunity to review any such analysis that SBV may have developed. We believe that our focus on overall, bottom-line performance was appropriate. We note that by SBV's own calculations, even using FY 2000 as the base year, its net gains have not kept pace with inflation.

SBV also faulted our observations for failing to go beyond net gain and examine the primary external market factors that drive SBV's two principal businesses: museum visitation and magazine advertising. SBV highlights three major achievements: it doubled sales per visitor, established three new lines of business with significant long-term value, and kept overall labor costs (excluding benefits) flat from FY 2001-2006, indicating success in SBV's pay-for-performance philosophy.

We agree that an analysis of executive compensation that is directly linked to financial performance should go beyond net gain to the key drivers of the respective business activities. As Institution and SBV executives have stated on more than one occasion, museum visitation is beyond SBV's control. The same holds for cyclical recessions in the magazine advertising industry. It is precisely for those reasons, as well as museum constraints imposed on SBV's operations and various limitations on the types of merchandise SBV can sell, that we have recommended the compensation model for SBV be re-examined. SBV, with its unique position within the Smithsonian, is not necessarily comparable to other commercial, stand-alone enterprises.

Sales per visitor may have doubled during the period, if you accept the reported visitation numbers (which we view with much caution, as noted in the Appendix E of this report). But we note that expenses grew somewhat more, yielding a bottom line that has eroded in real terms from the base year. In contrast, in recent years the national and local economies have seen healthy tourism numbers and commercial profits. In addition, our analysis does not reflect over $40 million in capital invested in SBV operations during the period. If we had fully factored capital investment into our analysis, SBV's financial results might have looked worse. Moreover, two of the three lines of business SBV describes as new are extensions of business activity the Institution engaged in before SBV was created. Further, based on draft projections, the bottom-line contributions of these two business lines are less than the $5 million "near-term" net gain figure cited in the response. Regarding the video-on-demand joint venture with Showtime Networks, management's projected long-term earnings of $50 million to $100 million (present value) assumes a contract period of up to 30 years. We note that the Government Accountability Office's recent report[19] points out that SBV's partner could walk away from the contract at certain points without cause. Moreover, other costs to the Institution, including lost productivity of staff resources not directly assigned to the contract and concerns about access to the collections, are unknown.

As for the success of the pay-for-performance approach, we note that in FY 2001, SBV's payroll costs increased $5.6 million, in nominal dollars, over FY 2000. Further, in FY 2001, SBV's unadjusted payroll costs (before benefits) equaled FY 2001's net gain of about $26.2 million. In 2006, payroll costs remained flat; however, they exceeded reported net gain by over $2 million. SBV also indicated that it initiated a restructuring in FY 2006 to reduce overhead and that according to a 2006 analysis by its compensation consultant, SBV's base pay was 3.4 percent below the market median. We note that the same study concluded that SBV's executive cash compensation was nearly 5 percent above the median.

SBV noted management's efforts to maintain revenues and improve the long-term quality of earnings. These improvements, however, have not offset the increased compensation SBV pays its top executives versus comparable pay levels in FY 1999, or the attendant infrastructure costs SBV incurred as a result of becoming a separate entity. These annual infrastructure costs are significant. For example, in 2006, the cost to maintain these functions, including its own human resources services, information technology support, accounting systems, and retail overhead, approached $8 million.

Finally, the Deputy Secretary, in responding to recommendation 8, only agreed to reevaluate compensation for the museum retail business. The Deputy Secretary cited successes in the magazine, travel, and publishing businesses, and the long-standing practice of paying market-based compensation to executives in those business lines as a rationale for not reexamining the other business activities or executives. Market-based

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[19] Smithsonian Institution: Additional Information Should Be Developed and Provided to Filmmakers on the Impact of the Showtime Contract, December 2006 (GAO-07-275).

compensation may be appropriate as an overall strategy, but the level of compensation may be too high given all the constraints and factors beyond SBV's control. Base salaries could be smaller and potential incentive bonuses larger for meeting or exceeding aggressive financial goals. The Institution would be better served if SBV executive compensation were aligned more closely with real, long-term sustainable growth in SBV's net gain.

APPENDIX A. SCOPE AND METHODOLOGY

SCOPE

Our analysis of SBV's financial performance extended from FY 1999, before SBV's full consolidation, through FY 2006. For our compensation analysis, our scope was FY 2000 to FY 2006 because payroll-related figures prior to FY 2000 were not comparable enough for an accurate analysis. To examine the process for approving compensation levels, we reviewed the period from FY 2000 to FY 2006. To review compliance with procedures, we reviewed activity from FY 2000 to FY 2006. And, to analyze financial data supporting the incentive plan payouts, we reviewed FY 2003 to FY 2006 financial information.

We conducted this audit in Washington, D.C. from April 2006 through December 2006 in accordance with Government Auditing Standards as prescribed by the Comptroller General of the United States and included tests of internal controls as we considered necessary.

METHODOLOGY

Compensation Levels

To determine how SBV sets compensation, we reviewed the role of compensation consultants and the Smithsonian's oversight of SBV's compensation practices. We reviewed recent compensation studies prepared by SBV's compensation consultants. We also met with one of the primary consultants to discuss their methodology and review how they assessed similar organizations' compensation and developed their recommendations to SBV. We reviewed whether SBV had implemented a compensation program in line with the consultants' recommendations. We assessed how the SI Board of Regents, SBV Board and SBV Compensation Committee oversee the compensation process through their reviews and approvals of SBV compensation levels. We reviewed all the minutes of the SBV Board of Directors meetings and SBV "Board Books" (detailed documents prepared for Board meetings) from SBV's inception in 1999 to 2006. We reviewed SBV Compensation Committee minutes for 2001 through 2005 to validate that committee members approved executive compensation levels.

We interviewed SBV management to determine how financial and operational goals are developed and approved for the plans. We discussed how SBV sets executives' financial management targets and how the targets link to SBV budgets. We reviewed SBV financial budgets and strategic plans for FYs 1999 to 2006. We also interviewed SBV staff to determine how operational goals were developed and approved.

To determine whether SBV compensation and incentive plans were in the same range as those at similar organizations, we benchmarked SBV against publicly traded companies with similar revenues and non-profit organizations with broad public reach. We compiled compensation information from 15 publicly traded companies, which we judgmentally selected from the retail, media, and restaurant service industries, with 2005 revenues ranging from \$150 million to \$200 million. We collected revenue and compensation data, which includes salary, bonus, and other allowances but excludes benefits such as contributions to 401K accounts and stock options, from the companies' public Securities and Exchange Commission filings from 1999 to 2005. We also gathered compensation data from 15 non-profit organizations with annual revenues under $950 million, ten of which had annual revenues between $100 million and $515 million. Non-profit organizations disclose executive compensation on the Internal Revenue Service Form 990, so we used that source to obtain information on their compensation of executives. The scope of our review of comparable non-profit compensation levels covered primarily the three most recent years (2003, 2004, and 2005); we extended our review to include additional years as far back as 1999 if the information was readily available.

Payments in Accordance with Policies and Procedures

To assess whether SBV made incentive compensation payments according to its procedures, we first identified SBV employees who participated in the incentive plan from 2000 to 2006 and the amount of incentives SBV paid them during that period. To determine total incentive payouts for FY 2000 to FY 2006, we reviewed spreadsheets of total compensation provided by the SBV human resources department for all incentive plan participants. We included the following in total compensation: base salary, incentive payments, cash awards, recruitment and relocation payments, severance payments, and any "other" payments. Next, we selected a sample of employee incentive plans to determine whether the plan had been signed by the participants and approved by the appropriate supervisors. Last, we determined how incentive awards were linked to performance by reviewing performance appraisals and incentive awards. We sampled 20 executive and division plan participants for FY 2004 and 19 participants in FY 2005.

To determine whether actual payments complied with the terms of the executive and division plans, we traced actual payments to employment agreements and other payroll records. We validated that actual results of financial and performance goals could be traced to financial reports and other supporting documentation. We evaluated the sources and reliability of data used to calculate compensation and bonus payments and to support the accomplishment of operational goals.

Data Supporting Incentive Plan Compensation Payments

To assess the reliability of the financial data used to support the incentive payments, we reviewed the Institution's external auditors' working papers for the FY 2004 and FY 2005 Smithsonian financial statement audits. We also examined their working papers for the review of SBV financial statements in FY 2003.

Because of concerns SBV identified with the accounting for its retail merchandising operation, we reviewed a September 2005 study of SBV's Retail Merchandise Accounts Payable System prepared by a consulting firm. We reviewed the two resulting large accounting adjustments that SBV made in FYs 2005 and 2006 to report the balances of accounts payable more accurately. We discussed with senior SBV management their concerns related to the accurate reporting of accounts payable activity, which included issues with the accounts payable system.

We interviewed SBV's accounting management to determine how SBV ensures that accounting information is accurately accumulated and recorded. We reviewed the general ledger from FY 2003 to the most current period available at the time of that review (May 2006) as well as certain supporting schedules. Our general ledger review consisted primarily of scanning revenue and expenses for large or unusual items, and discussing and reviewing supporting documentation with accounting management to determine if SBV had recorded the activity in accordance with generally accepted accounting principles. We reviewed selected supporting schedules to ensure that balance sheet disclosures could be supported and to understand if there were any significant impact on net gain. If the entries were incorrect, we assessed the entries' financial statement impact on reported net gain, which is used to justify incentive payments to SBV executives. When we had questions about particular entries during our general ledger review, we questioned SBV accounting management and gained an understanding of the underlying procedures and processes that may have caused the errors or adjustments.

SBV Financial Performance

To explain trends and variances and develop a source of financial data for use in the audit, we analyzed SBV's financial operating results. We obtained SBV's Operating Statements for the FY 2001 to FY 2006 period and the Smithsonian Institution's Unrestricted Funds Operating Statements for FY 1999 to FY 2000. In addition, we obtained information on the number of SBV employees, incentive compensation plans, museum visitation and other relevant information. We prepared spreadsheets for key financial measures, performance indicators, and for each of SBV's business lines, and analyzed SBV expenses by functional categories. We also prepared analyses of Executive and Division Manager base pay, incentive plan and bonus payments, and all other payments such as recruitment and relocation payments.[1]

We analyzed the data by calculating both annual and average growth rates; examining trends using tables and charts; interviewing SBV management; obtaining economic and inflation index data to further analyze SBV data; and performing variance analyses and reasonableness tests. We calculated an annual growth rate for SBV financial measures by calculating each year's growth rate and then dividing the sum of those rates by the number of years to obtain an annual average. To compare nominal and real (inflation-adjusted) growth and obtain a better understanding of SBV financial performance, we adjusted nominal dollar amounts reported in the Operating Statements and Unrestricted Funds Statements for the effects of inflation. We used annual inflation rates for each year based on the Consumer Price Index – All Consumers, with 1999 as the base year.[2]

[1] For our compensation analysis, our scope was FY 2000 to FY 2006 because figures prior to FY 2000 were not comparable enough for an accurate analysis.
[2] For purposes of analysis (and unless otherwise noted), we used inflation-adjusted figures as they more accurately represented real financial trends over the 8-year period.

APPENDIX B. TOTAL COMPENSATION OF SBV EXECUTIVES, 2000 - 2006

Name *Title*	2000	2001	2002	2003	2004	2005	2006
Tom Ott *President, Publisher*							580,842◆
Steve Shaiken *President, Retail Group*							416,118°◆
Gary Beer** *Chief Executive Officer*	443,180◆	466,393	453,275	470,973	558,075	499,240	350,040
Scott Rockman *Executive Vice President, Member Services*	301,246◆	230,000	252,771	279,000	355,022	332,447	280,834
[redacted]					83,559°	236,807	228,490
[redacted]					26,667°	210,999◆	224,756
[redacted]						142,533°	188,070◆
Gary Mercer *Chief Operating Officer, Museum Operations*		145,837°	228,437◆	212,083	284,989	271,279	156,802°◆
[redacted]							140,250
[redacted]							137,165°
Carey Winfrey *Editor-in-Chief*		41,667°	272,107◆	327,500	322,885	314,234	
[redacted]	123,000°◆	159,600	158,040	149,760	189,280	187,347	
Amy Wilkins *Publisher*		360,000◆	300,000	330,000	343,811	173,825°	
[redacted]	110,000	123,945◆	109,750	128,500	139,495	135,994	
Paul Wessel *Chief Financial Officer*	183,333°◆	223,667◆	212,737	195,750	162,431°◆		
Don Moser *Editor*	215,874	163,592	27,265°				
Ron Walker *Publisher*	257,300	131,083°					
[redacted]	180,000						
[redacted]	116,575						
[redacted]	115,088						
TOTAL	2,045,596	2,045,784	2,014,382	2,093,566	2,466,214	2,504,705	2,703,367

* Total compensation includes base salary, incentive awards, and all other allowances. Benefits such as health and life insurance are excluded. Severance is included only if payment was above the standard severance package required by the Institution. Executives listed are employees in the Executive Incentive Compensation Plan. We adjusted individuals' salaries from a calendar-year to a fiscal-year basis. The employee count used in Appendix E (Table 7) is generally based on executives who were employed as of January. FY 2006 compensation amounts are subject to final approval.

**Gary Beer is also eligible for a long-term incentive bonus.

° Base pay is prorated because the employee worked a partial year.

◆ Total compensation in year indicated includes one or more of the following: signing/recruitment/retention bonus, relocation payment, or severance payment

APPENDIX C. ORGANIZATIONS SURVEYED FOR SBV BENCHMARKING

Table 1. Fifteen Non-Profits Surveyed in Compensation Benchmarking

	Organization	Fiscal Year	Revenues
1	The Nature Conservancy	2005	$919,113,341
2	American Association of Retired Persons (AARP)	2004	$731,251,252
3	Public Broadcasting Service (PBS)	2005	$508,589,415
4	National Geographic Society	2004	$505,950,703
5	The J. Paul Getty Trust	2005	$398,522,993
6	The Museum of Modern Art	2005	$334,819,000
7	The Metropolitan Museum of Art	2004	$318,930,415
8	Wildlife Conservation Society	2005	$195,598,851
9	National Public Radio, Inc. (NPR)	2004	$165,960,176
10	The John F. Kennedy Center for the Performing Arts	2005	$155,306,550
11	National Gallery of Art	2004	$153,866,653
12	World Wildlife Fund, Inc. (WWF)	2005	$120,910,695
13	Harvard Business School Publishing Corporation	2005	$93,478,425
14	The United States Holocaust Memorial Museum	2005	$84,891,793
15	Woodrow Wilson International Center for Scholars	2004	$12,772,783

Table 2. Fifteen Publicly Traded Companies Surveyed in Compensation Benchmarking

	Company Name	Approx. 2005 Revenue ($ in millions)	Industry	Location	Business Description
1	Caribou Coffee Company, Inc.	198	Food Service	Brooklyn Center, MN	Operator of 395 coffeehouses, primarily in the U.S.
2	Young Broadcasting Inc.	197	Media	New York, NY	Owns and operates ten television stations in geographically diverse markets and a national television sales representation firm.
3	Alloy, Inc.	195	Media	New York, NY	Non-traditional media and marketing services company, primarily targeting persons in the U.S. between the ages of 10 and 24.
4	Bakers Footwear Group, Inc.	195	Retail	St. Louis, MO	National, mall-based specialty footwear retailer targeting young women (235 stores).
5	Penton Media, Inc.	193	Media	Cleveland, OH	Diversified business-to-business ("b-to-b") media company providing media products that deliver proprietary business information to owners, operators, managers and professionals.
6	Max & Erma's Restaurants, Inc.	184	Food Service	Columbus, OH	Operates 102 casual dining restaurants.
7	Big Dog Holdings, Inc	179	Retail	Santa Barbara, CA	Parent company of two retail chains, Big Dog USA, Inc. ("Big Dogs") and The Walking Company ("TWC").
8	BJ's Restaurants, Inc.	178	Food Service	Huntington Beach, CA	Operates 44 restaurants in California, Oregon, Colorado, Arizona, Texas, Nevada, and Hawaii.
9	eCost.com, Inc**	178	Retail	Torrance, CA	Leading multi-category online discount retailer of high quality new, close-out and refurbished brand-name merchandise.
10	The Coast Distribution System, Inc.	176	Retail	Morgan Hill, CA	One of the largest wholesale suppliers of replacement parts, supplies and accessories for recreational vehicles ("RVs") and boats.
11	S&K Famous Brands, Inc.**	176	Retail	Richmond, VA	Discount men's clothing retail store (240 stores).
12	Peet's Coffee & Tea, Inc.	175	Food Service	Emeryville, CA	Coffee roaster and marketer (sells through multiple channels of distribution).
13	Saucony, Inc.**	167	Retail	Peabody, MA	Designs, develops and markets performance-oriented athletic footwear, athletic apparel & casual leather footwear.
14	Design Within Reach, Inc.	158	Retail	San Francisco, CA	Markets & sells modern furniture & accessories through phone, studios & website.
15	Fisher Communications, Inc.*	149*	Media	Seattle, WA	Owns & operates 9 network-affiliated tv stations and 27 radio stations (primarily Seattle and Portland).

*Since 2005 sales were over $149 million, Fisher Communications was included in the $150-200 million revenue range grouping.
**eCost.com and Saucony revenues are from 2004. S&K Famous Brands revenues are from 2003.

APPENDIX D. BENCHMARKING OF SBV COMPENSATION

Table 1. Non-Profit Executive Compensation as Reported on IRS Form 990*

Organization	Revenues in Millions (Fiscal Year)	Title	Compensation	Expense Accounts and Other	Total Compensation
Publishing/Editorial Positions					
National Geographic Society	$506 (2004)	Executive VP, President, Magazine Group	$869,398	$0	$869,398
National Geographic Society	506 (2004)	Executive VP, Books	485,091	0	485,091
Harvard Business School Publishing Corporation	93 (2005)	Editor, Harvard Business Review	385,144	0	385,144
SBV	172 (2005)	Editor-in-Chief	257,000 (Base Pay)	58,984 (Incentive)	315,984
Harvard Business School Publishing Corporation	93 (2005)	VP, Director, Harvard Business School Press	275,200	0	275,200
SBV	172 (2005)	Publisher	266,475 (Base Pay)	0 (Incentive)	266,475**
Executive Vice Presidents (VP)					
The Metropolitan Museum of Art	319 (2004)	VP & General Manager for Merchandise & Retail	392,364	0	392,364
SBV	172 (2005)	Executive VP, Member Services	235,000 (Base Pay)	97,447 (Incentive)	332,447
National Gallery of Art	154 (2004)	External Affairs Officer	257,277	27,294	284,571
National Public Radio	166 (2004)	Executive VP	227,462	0	227,462
National Public Radio	166 (2004)	Senior VP	192,082	23,520	215,602
Chief Operating Officer (COO)/Operations VP					
The Museum of Modern Art	335 (2005)	COO/Assistant Treasurer	687,786	0	687,786
Harvard Business School Publishing Corporation	93 (2005)	Executive VP, COO, & CFO	568,631	0	568,631
SBV	172 (2005)	COO, Museum Operations	200,000 (Base Pay)	71,279 (Incentive)	271,279
World Wildlife Fund, Inc.	121 (2005)	COO	265,000	0	265,000
Wildlife Conservation Society	196 (2005)	VP, Operations	163,648	0	163,648
Chief Financial Officer (CFO)					
The Metropolitan Museum of Art	319 (2004)	Senior VP & CFO	303,024	0	303,024
Wildlife Conservation Society	196 (2005)	Executive VP & CFO	263,182	0	263,182
SBV	172 (2005)	CFO	185,000 (Base Pay)	51,807 (Incentive)	236,807
The John F. Kennedy Center for the Performing Arts	155 (2005)	CFO	214,797	0	214,797
World Wildlife Fund, Inc.	121 (2005)	CFO (partial year)	210,653	0	210,653

*Note: Data obtained from organizations' IRS 990 forms except for SBV data, which was obtained from Table 3 on p. 11. Compensation includes base salary and bonuses. "Other" includes fringe benefits such as housing and car allowances. Contributions to employee benefit plans and deferred compensation are not included. Compensation is listed for the same fiscal year as revenues.

**Employee worked a partial year and did not receive an incentive. Target incentive was $150,000, potentially increasing total compensation to $416,475.

Table 2. Compensation of non-CEO Executives at Publicly Traded Companies with Similar Revenues*

Company	Revenues in Millions (FY 2005)	Title	Salary	Bonus	Total Compensation
Executive Vice Presidents (VP)					
Alloy, Inc.	$195	CEO, Retail and Direct Consumer Division	$600,000	$0	$600,000
Penton Media, Inc.	193	Executive VP & President, Lifestyle Media & IT Media Groups	341,250	133,852	475,102
Bakers Footwear Group, Inc.	195	Executive VP, General Merchandise Manager	221,057	194,688	415,745
SBV	172	Executive VP, Member Services	235,000	97,447	332,447
Peet's Coffee & Tea, Inc.	175	VP, General Manager, Retail	329,846	0	329,846
Chief Operating Officer (COO)/Operations VP					
Caribou Coffee Company, Inc.	198	Senior VP of Store Operations	232,692	57,266	289,958
SBV	172	COO, Museum Operations	200,000	71,279	271,279
Peet's Coffee & Tea, Inc.	175	VP, Operations & Information Systems	213,193	0	213,193
The Coast Distribution System, Inc.	176	Executive VP of Operations	129,721	54,000	183,721
Max & Erma's Restaurants, Inc.	184	COO	135,829	10,600	146,429
Chief Financial Officer (CFO)					
Peet's Coffee & Tea, Inc.	175	VP, CFO & Secretary	361,019	0	361,019
Caribou Coffee Company, Inc.	198	CFO	269,367	85,482	354,849
The Coast Distribution System, Inc.	176	Executive VP & CFO	174,494	74,000	248,494
Max & Erma's Restaurants, Inc.	184	Executive VP, CFO, Treasurer & Secretary	205,950	32,411	238,361
SBV	172	CFO	185,000	51,807	236,807

*Note: Data is from SEC filings except for SBV data, which was obtained from Table 3 on p. 11. Benefits and stock options are not included. 2005 revenues for the companies selected are between $150-200 million. 2005 SBV revenues were $172 million. Salaries are listed for the same fiscal year as revenues. The Caribou Coffee Senior VP of Store Operations also received relocation expenses and other benefits totaling $45,225. The Penton Media Executive VP & President, Lifestyle Media & IT Media Groups, also received a $30,000 long-term incentive payout.

APPENDIX E. FURTHER ANALYSIS OF SBV'S FINANCIAL PERFORMANCE

As we noted in the body of the report, we reviewed SBV's overall financial performance from FY 1999 through 2006. We based our analysis on SBV's own figures as well as on data gathered by and for the Smithsonian. The following discussions and tables provide additional information to supplement our report observations.

SBV Financial Performance Has Declined

Tables 1, 2, and 3 below present nominal and inflation-adjusted figures for revenues, operating expenses, and net gain, respectively. Growth rates, or in some cases, declines, are shown for each year. In the last column of the table we show the average growth or decline rate for all years. For revenues and net gain, average annual rates were negative over the 8-year period. Inflation-adjusted operating expenses were relatively flat over the period.

Table 1. Total Revenues (dollars in 000s)

	1999	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Nominal	$155,526	$153,687	$160,658	$144,466	$143,091	$154,150	$171,724	$164,356	*$155,957*
Adjusted	$155,526	$148,689	$151,132	$133,785	$129,559	$135,952	$146,489	$135,822	*$142,119*
Percent Change, Adjusted	N/A	-4%	2%	-11%	-3%	5%	8%	-7%	*-2%*

Table 2. Operating Expenses (dollars in 000s)

	1999	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Nominal	$92,840	$94,246	$104,160	$100,837	$96,472	$98,629	$107,448	$111,532	*$100,771*
Adjusted	$92,840	$91,181	$97,985	$93,382	$87,349	$86,986	$91,658	$92,169	*$91,694*
Percent Change, Adjusted	N/A	-2%	7%	-5%	-6%	0%	5%	1%	*0%*

Table 3. Net Gain (dollars in 000s)

	1999	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Nominal	$27,860	$25,073	$26,240	$16,815	$20,579	$27,423	$30,011	$23,927	*$24,741*
Adjusted	$27,860	$24,258	$24,684	$15,572	$18,633	$24,186	$25,601	$19,773	*$22,571*
Percent Change, Adjusted	N/A	-13%	2%	-37%	20%	30%	6%	-23%	*-2%*

Note: Some of the calculated figures in the appendices may have been rounded.

We noted the drop in revenues and net gain in FY 2002 (the aftermath of September 11) and the subsequent recovery in FYs 2003 to 2005. We also noted that inflation-adjusted revenues and net gain for FY 1999 through FY 2001 were significantly higher than inflation-adjusted revenues and net gain from FY 2002 to FY 2006 (with the exception of FY 2005 net gain), indicating that earnings in those earlier years were healthier than in recent years and that SBV has had difficulty keeping pace with inflation. Currently, the decrease in FY 2006's inflation-adjusted revenues and net gain has brought SBV's financial performance down to one of its lowest levels since inception and has ended a steady 3-year upward trend. The drop has been attributed by SBV management to a significant falloff in visitorship and weak demand in the catalogue business compounded by certain operational problems.

One of SBV's performance indicators is its net gain margin (i.e., net gain divided by total revenues), which shows the profit percentage for each dollar of revenue earned. This indicator varied in a range from 18 percent in FY 1999 to 12 percent in FY 2002. We noted the change since inception, where an 18 percent net gain margin declined to 15 percent in FY 2006 (i.e., SBV earned about $0.18 on each dollar of revenue in FY 1999 and $0.15 in FY 2006), indicating an overall decline in net return on revenues since FY 1999.

Table 4. Net Gain Margin

	1999	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Net Gain Margin	18%	16%	16%	12%	14%	18%	17%	15%	*16%*

Other performance measures we considered were revenues and net gain per employee. These ratios can be considered to be measures of employee productivity or efficiency. Table 5 on the next page shows these measures over the 8-year period. Inflation-adjusted revenue per employee, on an average annual basis, was unchanged over the 8-year period. Inflation-adjusted net gain per employee decreased an average of one percent per year over the period.

Table 5. Inflation-Adjusted Indicators Per Employee (in 000s)

	1999	2000	2001	2002	2003	2004	2005	2006	*Average*
Revenue per Employee	$283	$267	$279	$291	$319	$324	$296	$283	*$293*
Percent Change	N/A	-6%	4%	4%	10%	1%	-9%	-4%	*0%*
Net Gain per Employee	$51	$44	$46	$34	$46	$58	$52	$41	*$46*
Percent Change	N/A	-14%	5%	-26%	36%	25%	-10%	-20%	*-1%*

Reported Smithsonian visitorship, as adjusted,[1] peaked in FY 2001 at 30 million. In FY 2002, however, due to the events of 9/11, visitorship dropped 8 million to 22 million, a 27 percent decline. Since FY 2002, visitorship has fluctuated in a range from 17 million to 23 million. Average attendance during the 8-year period was 24 million.

Table 6. Smithsonian Visitorship (in 000s)

	1999	2000	2001	2002	2003	2004	2005	2006	Avg.
Visitors	26,000	29,000	30,000	22,000	23,000	17,000	22,000	20,000	24,000
% Change	N/A	12%	3%	-27%	5%	-26%	29%	-9%	-2%

Other key performance measures are revenues per visitor and net gain per visitor.

These measures relate to business lines serving visitors directly (collectively known as retail operations), such as museum stores, theaters, food and beverage concessions, and other types of concessions. Inflation-adjusted retail revenue per visitor in FY 1999 was $1.35. In FY 2006, the same measure was $2.53, reflecting a $1.18 increase over the period. Inflation-adjusted retail net gain per visitor in FY 1999 was $0.29. In FY 2006, the same measure was $0.59. These results represented approximately a doubling of the performance measures over the 8-year period.

Of note was the impact the National Museum of the American Indian and the National Air and Space Museum's Steven F. Udvar-Hazy Center had on the revenue and net gain per visitor. Before the opening of the museums and the additional theater in FY 2004, adjusted revenue and net gain per visitor in FY 2003 were $1.77 and $0.35, respectively. After the opening of the facilities, adjusted revenue and net gain per visitor jumped to $2.92 and $0.73 for FY 2004. In FY 2006, revenue and net gain per visitor dropped to $2.53 and $0.59, respectively.

Executive and Senior Manager Compensation Has Grown as a Percentage of Revenue and Net Gain over the 7-Year Period

Over the 7-year period,[2] adjusted executive compensation grew an average of two percent annually, a modest rate of growth but four percent greater than the two percent average decline in net gain. In relation to revenues and net gain, both of which

[1] These visitor numbers exclude the Freer Gallery, Sackler Gallery, Cooper-Hewitt Museum, and the National Zoological Park because museum shops at these locations are not managed by SBV. Visitor numbers are reported in the Budget Justification to Congress based on figures compiled by the Office of Protection Services. We did not audit these numbers, and we believe that visitor numbers should be viewed with caution due to difficulties in counting and compiling accurate figures. We did not obtain an explanation for the large drop in reported visitors in 2004.

[2] While our overall analysis of performance covered FY 1999 to FY 2006, for our compensation analysis we began with FY 2000 data because FY 1999 data was not sufficiently comparable to make an accurate analysis. All compensation figures have been adjusted for inflation using 1999 as a base year to make compensation figures comparable to the other inflation-adjusted figures in this report.

influence the determination of incentive pay, executive compensation was relatively stable at one to two percent of revenues, but for net gain increased modestly from 8 percent in FY 2000 to 11 percent in FY 2006.

Table 7. Total Executive Compensation (dollars in 000s)

	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Adjusted	$1,979	$1,925	$1,865	$1,897	$2,174	$2,137	$2,234	*$2,030*
Percent Change	N/A	-3%	-3%	2%	15%	-2%	4%	*2%*
Percent of Revenue	1%	1%	1%	1%	2%	1%	2%	*1%*
Percent of Net Gain	8%	8%	12%	10%	9%	8%	11%	*10%*
No. of Executives	10	8	8	8	8	10	9	9

Senior Manager Compensation

Over the 7-year period, senior manager compensation in total grew an average of one percent annually. Senior management compensation was steady at four percent of revenues. Further, senior management compensation as a percent of net gain grew from 23 to 29 percent over the 7-year period, with an average of 26 percent. As noted, during the same period, net gain declined an average of two percent per year (see Table 3 on page E-1).

Table 8. Total Senior Manager Compensation (dollars in 000s)

	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Adjusted	$5,564	$5,374	$5,663	$5,077	$5,021	$5,822	$5,718	*$5,463*
Percent Change	N/A	-3%	5%	-10%	-1%	16%	-2%	*1%*
Percent of Revenue	4%	4%	4%	4%	4%	4%	4%	*4%*
Percent of Net Gain	23%	22%	36%	27%	21%	23%	29%	*26%*
No. of Sr. Managers	75	78	75	60	58	68	58	*67*

Executive and Senior Manager Incentive Awards

Executive and senior manager incentive awards as a percent of net gain fluctuated between one and two percent over the 7-year period, resulting in little to no change in the relationship of incentive awards to net gain.

Table 9. Total Inflation-Adjusted Executive and Senior Manager Incentive Awards (dollars in 000s)

	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Executives	$397	$268	$256	$334	$568	$459	$337	*$374*
Incentive Award as Percent of Net Gain	2%	1%	2%	2%	2%	2%	2%	*2%*
Senior Managers	$236	$274	$244	$316	$471	$438	$435	*$345*
Incentive Award as Percent of Net Gain	1%	1%	2%	2%	2%	2%	2%	*2%*
Net Gain	$24,258	$24,684	$15,572	$18,633	$24,186	$25,601	$19,773	*$ 21,815*

Payroll Expenses (Excluding Benefits[3])

SBV's unadjusted payroll (salaries, incentive awards, and other compensation) has averaged $23,101,000 annually over the 7-year period (see Table 10). Executive compensation as a percent of payroll expense was 10 percent, on an annual average basis, fluctuating between 8 and 11 percent over the period. In terms of numbers of employees, executives as a percent of all SBV employees averaged two percent over the period.

Senior manager compensation as a percent of payroll expense averaged 26 percent per year within a range of 22 to 28 percent over the 7-year period. The number of senior managers averaged 14 percent of all SBV employees over the period.

Combined, executive and senior manager compensation averaged 36 percent of payroll over the 7-year period, with a high of 38 percent and a low of 30 percent. The number of executives and senior managers as a percent of all SBV employees was 16 percent over the 7-year period, fluctuating little between years.

Table 10. Unadjusted Payroll Costs (dollars in 000s)

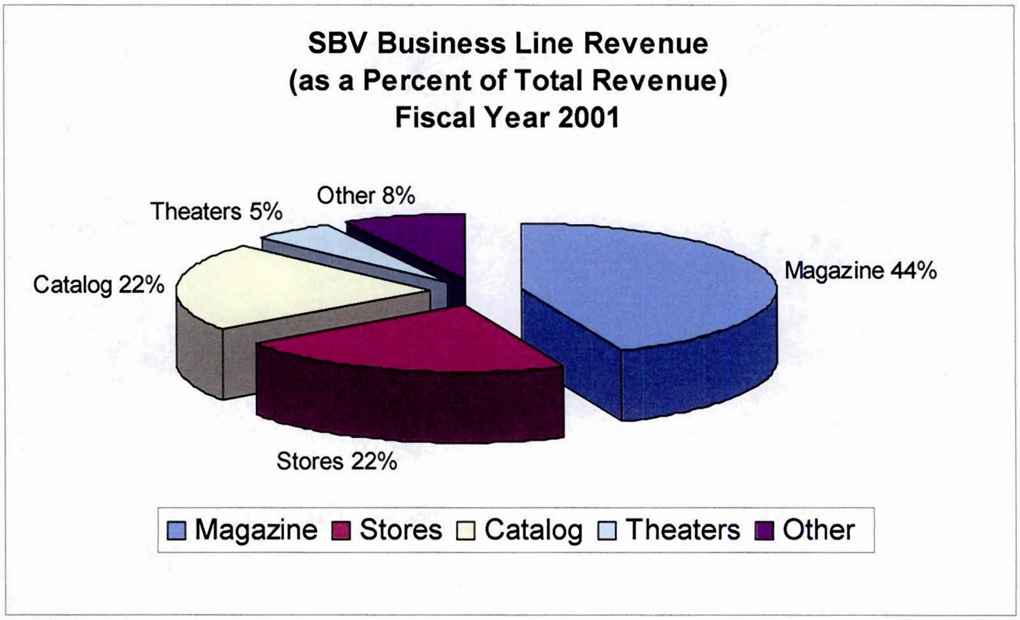
	2000	2001	2002	2003	2004	2005	2006	*Avg.*
Payroll (less benefits)	$20,623	$26,205	$21,869	$20,169	$21,761	$24,783	$26,294	*$23,101*
Exec. Comp as Percent	10%	8%	9%	10%	11%	10%	10%	*10%*
Sr. Mgr. Comp. as Percent	28%	22%	28%	28%	26%	28%	26%	*26%*
Total Percent of Payroll	38%	30%	37%	38%	37%	38%	36%	*36%*

[3] We excluded benefits from our analysis because we did not have precise figures for Executive and Senior Manager benefits.

Business Lines – Revenues and Net Gains

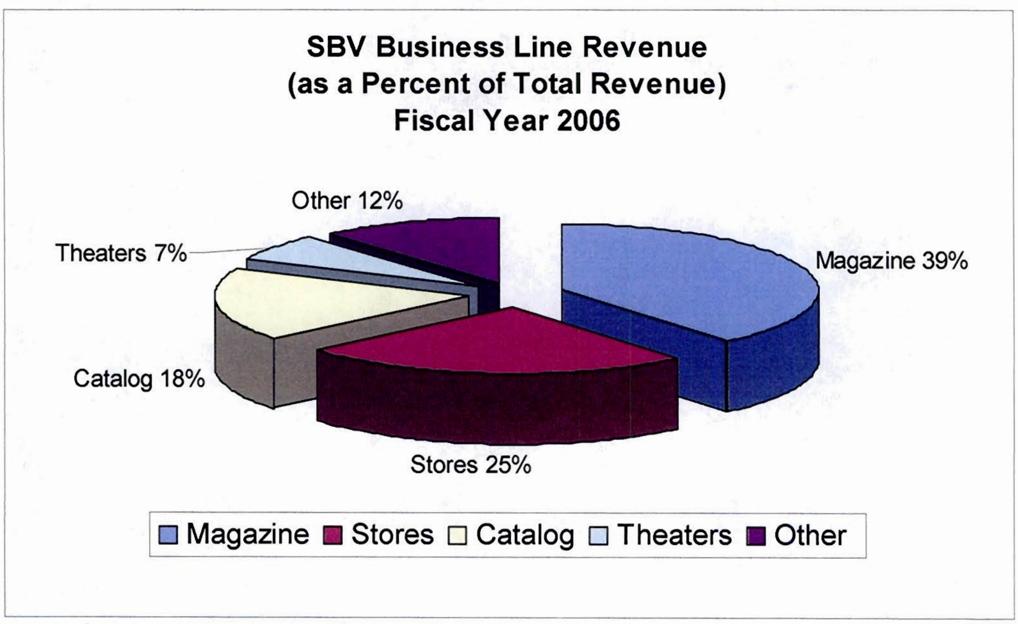
The following four charts provide a perspective on the relative increases and decreases in the proportionate contribution of SBV's various lines of business to revenues and net gain between FY 2001 and FY 2006. From FY 2001 to FY 2006, the percentage of revenue from Magazine and Catalogue activities decreased. During the same period, the percentage of revenue from Stores and Theater operations increased. Net gain showed a similar pattern.

Chart 5



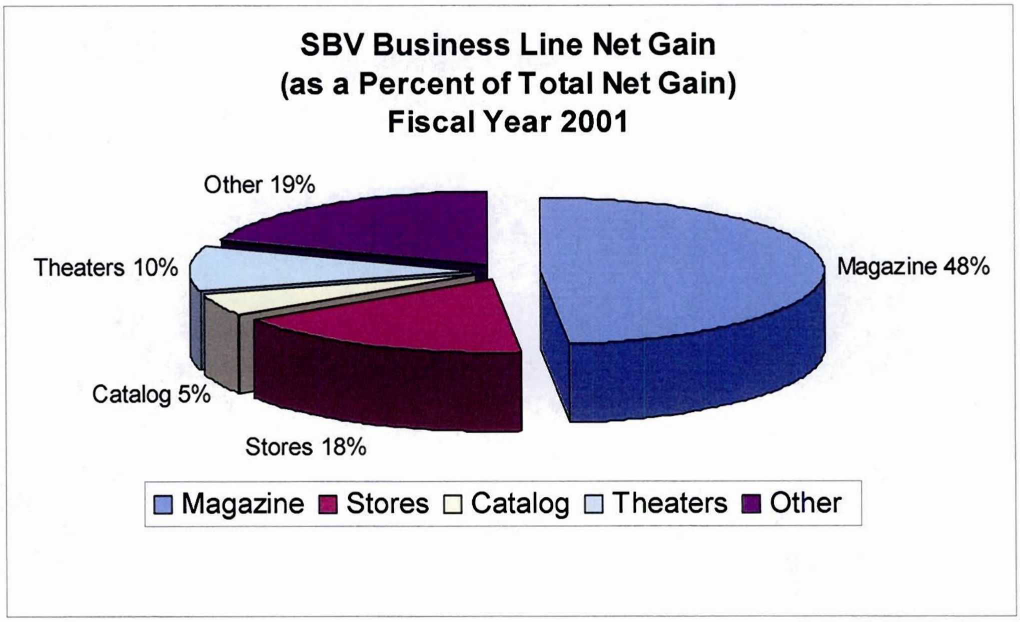
Source: SBV Operating Statements.
Note: Due to rounding, total percentages may not equal 100%.

Chart 6



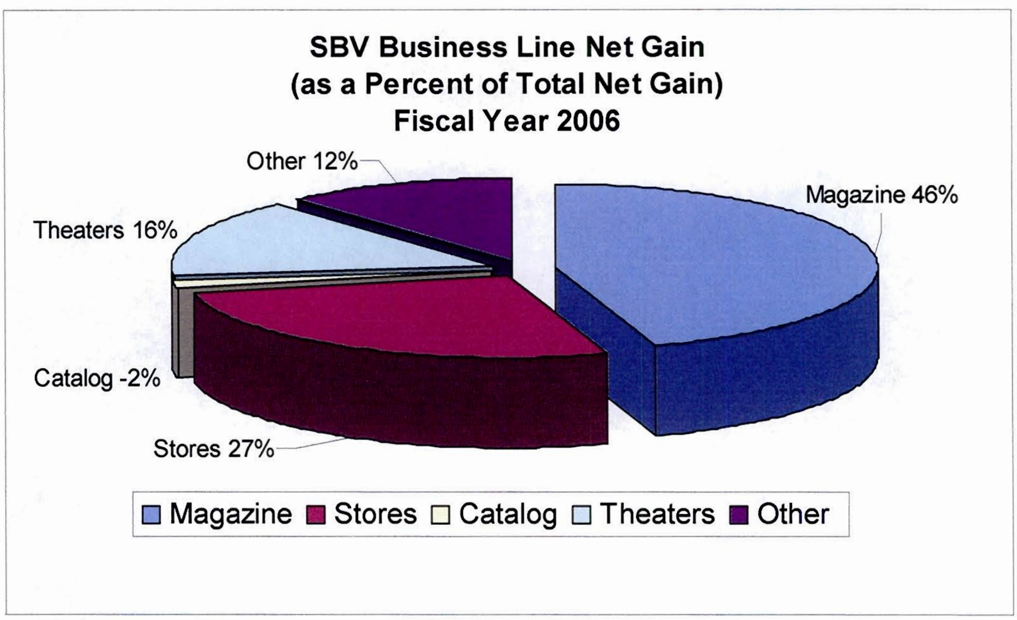
Source: SBV Operating Statements.
Note: Due to rounding, total percentages may not equal 100%.

Chart 7



Source: SBV Operating Statements.

Chart 8



Source: SBV Operating Statements.
Note: Catalog figure is negative due to a net loss in 2006. Due to rounding, total percentages may not equal 100%.

APPENDIX F. MANAGEMENT RESPONSES

Smithsonian Business Ventures

Gary Beer
Chief Executive Officer

Memo

Date: January 17, 2007

To: Sprightley Ryan, Acting Inspector General

cc: Secretary Lawrence Small
Deputy Secretary Sheila Burke
General Counsel John Huerta
Chief Financial Officer Alice Maroni

From: Gary Beer, CEO

Subject: Comments on Audit Report on Executive Compensation at SBV, Phase I, No. A-06-02

The following comments represent the response of Smithsonian Business Ventures (SBV) management to the findings and recommendations of the Inspector General's (IG) Audit Report on Executive Compensation. Firstly, I would like to note our appreciation for the effort that the Inspector General and her staff took to understand a large, complicated body of information and to approach this audit in a fair and unbiased way.

As you know, the report includes personal salary and compensation data for existing and past employees. Under Smithsonian Trust policy and practice, this information is considered confidential; management believes that disclosure of this would create organizational hardships, and therefore respectfully requests that individual salary data be redacted from any public distribution not authorized by the Secretary or the employee.

The compensation philosophy for SBV was expressed as a goal by the Board of Regents in 1998 and executed in stages as we developed the capability to do so. As the program has expanded from the top executives to Divisional managers, we recognized the need to improve administration. Most recently, in 2006, SBV hired an executive with strong experience in performance-based plans and organizational change to lead Human Resources. Some of the initial improvements that we are making include: improving the clarity and quality of operational goals, finalizing individual incentive plans earlier in the fiscal year, and increasing communication regarding plan parameters to ensure consistency.

SMITHSONIAN INSTITUTION
Office of the CEO
1000 Jefferson Drive SW Room 124
Washington DC 20560-0038
202.633.5169 Telephone
202.786.9147 Fax

Notwithstanding the improvements that are needed, we are proud of the accomplishment of performance-based compensation. SBV implemented a company-wide pay-for-performance compensation system in 2002 based on best practices in the private sector. SBV rewards employees for performance via merit increases in base pay and does not pay cost-of-living allowances. This has resulted in SBV's ability to maintain a low overall increase in labor costs, and maximize net gain contribution to the Institution.

Through defined incentive plans, we are adding discipline and accountability to a system that previously was based on discretionary cash awards. We believe that the program has been effective overall in rewarding top executives for achieving or exceeding earnings goals, and reducing compensation when earnings are not achieved. Incentive plans that are discretionary in nature are very common in the private sector. SBV's incentive plan offers some discretion for management in determining the annual operational goals and, to a lesser extent, participation in the plan. Integrating these business goals from the top level down to the middle managers is a basic private sector practice that works and, while financial metrics must be directly attributable to net gain, there must be some discretion by managers at the operating level.

The financial accounting system we have in place is a significant step forward in providing visibility and accountability into business activities where, in some cases, little existed. And the weaknesses that do exist are being identified and cured by SBV managers as we find them. The enhancement of our financial planning, accounting and controls is a priority for management and the SBV Board. We have invested substantially over the last four years to put the people and tools in place. We welcome your involvement and advice in the short and long term decision-making about priorities and investment in the accounting system and related functions.

Overview of Response

SBV generally agrees with the findings in the report, with exceptions outlined below in this response. SBV is particularly pleased that, with regard to the primary focus of this phase of the report, the IG found that "SBV has established a Comprehensive Compensation Process" and that "SBV Compensation is in the Range of Similar Organizations," conclusions that respond to two questions at the heart of this audit. The IG also found areas for improvement and change (the basis for its recommendations), some of which SBV is already in the process of addressing and some which provide a helpful third-party perspective to inform SBV's goal setting and workplans.

While such a thorough review of any complicated management performance system is bound to find areas for improvement, we are also pleased, but not surprised, that none of the findings suggest that any management actions have been inappropriate or improper.

SBV agrees with the recommendations outlined by the IG, with the exception of the final one, and will either continue work that was underway to improve systems or develop and implement new procedures designed to address the specific recommendations.

SECTION I: SBV EXECUTIVE COMPENSATION

As mentioned above, SBV is pleased that two of the three primary findings with respect to SBV Compensation reaffirmed two of its primary tenets, namely that "SBV has Established a Comprehensive Compensation Process" and "SBV Compensation is in the Range of Similar Organizations." However, the third finding, that "SBV's Implementation of its Compensation Policy Needs Improvement" was the basis for the IG's first five recommendations.

Recommendations #1-5

1. Any payments of incentive bonuses based on exceptions from approved financial and operational goals are justified and documented in writing at the time of the award.

2. Managers establish operational goals at the beginning of the fiscal year and that incentive plan worksheets are properly documented with supervisor and employee signatures and dates.

3. Operational goals are specific and measurable and can be clearly linked to improved organizational results.

4. Managers approve performance plans at the beginning of each year and complete written summary performance appraisals for all individuals promptly at year's end.

5. SBV develops a 3- to 5-year strategic plan for approval by the SBV Board of Directors and the Secretary. Annual financial targets and actual performance should be reconciled to approved long-term plan goals and considered when making compensation decisions. Measurable operational goals that are long-term drivers of net gain should be more closely linked to growth strategies in approved long-term strategic plans.

Response to Recommendations #1-5

Concur. Management concurs with the Audit recommendations for enhancing administration of the annual performance management system, as well as the opportunities to improve the synchronization of long term plans with annual performance and incentive goals, when appropriate. Management has already initiated steps at the outset of FY 2006 to improve support and administration of the program, having identified some of the shortcomings mentioned in the report, including the recruitment of a new Vice President of Human Resources with significant experience in executive compensation, and the issuance of revised guidelines for the program. The recommendations are also consistent with the existing performance plan guidance implemented for FY 2007 that requires annual operating goals to be "S.M.A.R.T." (Specific, Measurable, Attainable, Results-oriented and Time-bound). We believe that these guidelines are consistent with the recommendations made. Most importantly, a renewed focus on assuring sufficiency of supporting documentation both for standard documentation as well as exceptions granted will be undertaken.

Recommendations #1-4 will be implemented through updated guidelines for incentive plan administration to be issued in advance of the FY 2008 Budget and the long term plan cycle in Q4 of FY 2007. With respect to documentation, this will be addressed via a formal 'Final Report and Review' of the performance plan that will occur annually with the CEO and SBV HR, which will include a complete checklist of required submissions both for the completed fiscal year and the next upcoming fiscal year. This will be undertaken at the end of FY 2007 and completed in conjunction with the Regents' compensation approval process (which typically occurs at the end of January).

Recommendation #5 will require annual review. For FY 2008, a long term plan (traditionally covering three fiscal years) will be developed in conjunction with the budget to be approved by the SBV Board and the Secretary. Long term financial goals drawn from this plan will be reviewed annually by the Compensation Committee of the SBV Board in concert with recommendations for executive compensation and incentive plan targets, beginning with FY 2008.

SECTION II: OBSERVATIONS ON SBV ACCOUNTING SYSTEM

The audit also notes many areas for improvement of the SBV accounting system, some of which SBV previously identified and was addressing and others that will be the source of renewed review and interest.

Recommendation #6
All out-of-period adjustments as well as unusual and nonrecurring items are tracked and accumulated for internal management purposes.

Response to Recommendation #6
Concur. It is management's understanding that the recommendation to track "all out-of-period adjustments" relates to the small or minor adjustments that may require closer attention to ensure there is no material impact on payout of an individual plan or specific financial metric, and concurs with the recommendation. Management and the Compensation Committee of the SBV Board from the outset of the program have made diligent efforts to ensure that unusual, non-recurring, or extraordinary items are appropriately identified, and that compensation for such items is fairly treated. Management believes that all material items of this nature have been identified and appropriately addressed for FY 2000-2006.

Recommendation #6 will be implemented with guidance to the SBV Controller on all annual financial metrics that are subject to financial incentives in that year, and the Controller will provide quarterly updates on items which are material so that when incentive plan payouts are calculated, all appropriate information will be incorporated. This process will be implemented immediately and will impact current year FY 2007 calculations.

Recommendation #7
An annual examination-level attestation engagement by an independent public accountant is performed on SBV's net gain and other key financial measures to ensure that SBV's reported financial results are complete, accurate, and reliable for calculating annual incentive awards as well as for other Institution uses.

Response to Recommendation #7
Concur. Management supports the recommendation to supplement the Institution's annual audit with a more detailed review of the key net gain metrics of SBV businesses and believes that such a review is sufficiently advantageous to minimize the cost and management resources required.

For Recommendation #7, SBV relies on the Institution to conduct the annual audit and, thus, to implement this recommendation. SBV's CFO will work with the Institution's CFO and external auditors to identify the appropriate actions.

SECTION III: SBV'S FINANCIAL PERFORMANCE

While the IG concluded that an analysis of SBV financial performance was necessary for its own review, it should be noted that this analysis was not within the scope of the audit. Further, management believes that the review conducted does not address nor factor in a number of important variables, including market conditions and management's actions to address them, appropriate time frames, long term value-creation activities, or benchmarking (which the IG itself utilized in its analysis of SBV compensation levels), all of which are critical to an accurate assessment of financial performance and would be consistent with a more thorough analysis. Furthermore, the report does not acknowledge that the Institution has been paying market-based compensation for over 30 years to employees of *Smithsonian* magazine and the Museum Retail Stores and Catalogue.

Recommendation #8
Re-examine whether market-based compensation is the appropriate strategy for SBV and, if so, whether the level and types of executive compensation provide the most effective incentives to achieve long-term net gain growth.

Response to Recommendation #8
Any actions associated with Recommendation #8 would be at the Secretary's discretion. The Secretary responded in a separate management comment dated January 12, 2007 and clearly stated his objection to a reexamination of whether market-based compensation is the appropriate strategy for SBV. Business Ventures management would encourage the Secretary's review of comparable efforts made to attract and retain senior executives with the skills necessary to manage like business operations, external business conditions, and the ability to develop new lines of business to accomplish growth.

Management has identified certain factual inconsistencies in the analysis of financial performance, as well as the methodology utilized, and does not believe that an examination is warranted based on the audit's findings. Specifically:

1. The financial results presented exclude $6.5 million of net gain earned in FY 2005 from the early termination of the MBNA affinity card. The exception of MBNA earnings from SBV's audited total net gain is inconsistent with the methodology employed for all other fiscal years in the period in which total net gain is used, including extraordinary items, both positive and negative.

2. The findings on SBV's financial performance are premised on an estimate of net gain in FY 1999, the year before SBV management was installed and for which reliable financial statements are not available (as the report itself references), while future fiscal year net gain figures compared are from the audited financial statements prepared in accordance with GAAP.

3. The FY 1999-2006 period is a subjective eight year 'point-to-point' analysis which could be reasonably changed to demonstrate a different outcome:

   a. If the analysis were based on FY 1999-2005 historical performance, adjusted for inflation and including the MBNA termination settlement (per item #1 above), growth would be +14% versus the -28% in the report.

   b. If the analysis were based on FY 2000-2006, the actual year that SBV management was installed (assuming MBNA program had continued, $2.0 million FY 2006 impact), the performance over the period is -11% vs. the -28% presented.

Furthermore, the 'point-to-point' nature of the analysis and the conclusions drawn from it do not take into account external impacts to the business operations during the course of that time period, both positive and negative (most notably the impact of 9/11, the effect of the Iraq war on visitation to Washington DC, and new museum openings and closings). During the magazine advertising industry recession from 2001-2004, the overall market declined 15-18% in both ad revenue and pages sold for monthly consumer magazines such as *Smithsonian.*

4. An analysis of financial performance, and ultimately management effectiveness, would not be limited to financial net gain, but would take into account external market factors which are the key drivers of SBV's two principal businesses: museum visitation and magazine advertising; and the specific efforts of management to maintain revenues and improve long term quality of earnings. For example, over the period, management effectively:

   a. Doubled sales-per-visitor from $1.24 to $2.50. This amounted to $25.2 million of incremental revenues in FY 2006, a 63% increase over FY 1999, during a period when museum visitation declined from 28 million to 20 million (-29%). This metric is one example of a much more appropriate measure and one where the results have been excellent.

b. Established three new lines of business with a significant long-term value. New businesses formed by SBV account for over $5 million of near-term net gain (HarperCollins trade book publishing and Smithsonian Student Travel partnership) and long-term earnings from the video on demand joint venture with CBS/Showtime are projected to be in the range of $50-100 million in present value depending on the timeframe analyzed.

c. Managed labor costs via its 'pay-for-performance' program. Merit increases granted by SBV have been lower than both the COLA increases granted by the Institution and the general wage increases over the past seven years. Overall SBV payroll costs (excluding benefits) from FY 2001-2006 were flat at $26.3 million (Table 10) despite one of the tightest labor markets in the country and the launch of incremental lines of business and new retail locations, indicating success in SBV's pay-for-performance philosophy.

   It is also relevant to note that SBV executive compensation, adjusted for inflation, has been held nearly flat over the seven year period presented, despite the addition of three new lines of business since the base year. In FY 2006, SBV initiated a restructuring to reduce overhead and mitigate a downturn in business driven by the closure of NMAH, as well as general declines in museum visitation levels. As a result of the restructuring, SBV executive compensation in FY 2007 will actually be at the same nominal amount as FY 2000. Further, prior to this restructuring, SBV base pay was 3.4% below the market median, according to the 2006 Competitive Market Analysis conducted by Watson Wyatt, a nationally recognized compensation consultant.

Smithsonian Institution

Memo

Deputy Secretary and Chief Operating Officer

Date January 12, 2007

To A. Sprightley Ryan, Acting Inspector General

cc Lawrence M. Small, Secretary
Gary Beer, CEO, Smithsonian Business Ventures
Alice C. Maroni, Chief Financial Officer

From Sheila P. Burke SB
Deputy Secretary and Chief Operating Officer

Subject Management Response on Executive Compensation at Smithsonian Business Ventures, Phase 1, Number A-06-02—Recommendation #8

Thank you for the opportunity to respond to your draft audit report on Executive Compensation at Smithsonian Business Ventures (SBV). The report contains eight recommendations, seven of which are directed at the Chief Executive Officer (CEO) of Smithsonian Business Ventures who will provide management comments directly to you. The eighth recommendation is to the Secretary of the Smithsonian. This memorandum provides management's response to the report's eighth recommendation.

Recommendation 8:

The report recommends that the Secretary of the Smithsonian:

> Reexamine whether market-based compensation is the appropriate strategy for SBV and, if so, whether the level and types of executive compensation provide the most effective incentives to achieve long-term net gain growth.

Response

Management does not agree with the recommendation to reexamine whether market-based compensation is the appropriate strategy for SBV. The IG has confirmed SBV's market-based executive compensation is comparable to the pay of those doing similar work in the for-profit and not-for-profit sectors. Presumably, the alternative to market-based compensation is below-market compensation and it does not seem probable that such a strategy, broadly employed, would be likely to attract, retain and motivate qualified staff.

For example, one of SBV's principal businesses, *Smithsonian* magazine, has succeeded over more than three and a half decades in becoming one of the highest regarded publications in the United States and has produced over $350 million for the Institution. *Smithsonian* magazine has been offering market-based compensation for over 30 years. Consequently, reevaluating this obviously successful approach to attracting, retaining and

Smithsonian Institution Building. Room 219
1000 Jefferson Drive, SW
Washington DC 20560-0017
202.633.5240 Telephone
202.357.7031 Fax

motivating top quality staff for the Smithsonian's magazine businesses does not appear to have any compelling rationale behind it.

Similarly, businesses like SBV's travel and publishing businesses are doing well in competing head-to-head with other entities offering analogous products and services in the marketplace. Expecting that these businesses can attract, retain and motivate executive talent by offering compensation below what their competitors offer would seem to have no compelling rationale either.

On the other hand, the competitive positioning of SBV's museum retail business does, in the view of the Smithsonian's leadership warrant revaluation.

It is clear the level of museum visitation is the dominant variable in the success of SBV's museum retail business. But SBV executives, in reality, have little to do with driving how many people visit the Smithsonian's museums, the latter being subject to Washington tourism levels, new museum exhibits and the like. Clearly, SBV's stores are not a primary reason for museum visitation and SBV's museum retail executives have no significant influence on the traffic coming into the museums where retail operations are located. While they do have opportunities to influence the percentage of those visitors attracted to retail operations once they're in the museum, the fact is, managing museum retail stores is not the same as managing freestanding operations where there are clear strategic alternatives available to influence customer volume.

Consequently, Smithsonian leadership does feel a review of SBV's approach to those parts of its compensation program related to its museum retail activities warrant a reevaluation.

Such a review will be completed in time to have its findings and recommendations presented to the SBV board and the Regents Compensation and Human Resources Committee spring meeting so that if changes are warranted they can be put in place for FY 2008