Smithsonian Institution

Office of the Inspector General

March 29, 2010

Audit and Review Committee, Board of Regents
Smithsonian Institution
Washington, DC 20560

Dear Members of the Audit and Review Committee:

The Office of the Inspector General (OIG) serves as the Smithsonian's Contracting Officer's Technical Representative for the oversight of the Smithsonian's annual financial statement audits conducted by the independent certified public accounting firm, KPMG LLP. This letter presents our observations on the FY 2009 audit process for the Smithsonian's Federal Closing Package (federal appropriations reporting), the Smithsonian's Financial Statement Audit (combined federal and trust reporting), and the Smithsonian Enterprises special-purpose Statement of Net Gain. This letter also contains suggestions for improving the process for the FY 2010 audit cycle and beyond. We also summarize KPMG's FY 2008 audit of the Smithsonian's federal awards, which it performed in accordance with U.S. Office of Management and Budget Circular A-133.

Our review, as differentiated from KPMG's audits, which it conducted in accordance with the American Institute of Certified Public Accountants' (AICPA) generally accepted auditing standards (GAAS) and GAO's *Government Auditing Standards*, was not intended to enable us to express, and we do not express, an opinion on the Smithsonian's financial statements, internal controls, or compliance with laws and regulations. KPMG is responsible for the auditors' reports and the conclusions therein.

We found no instances where KPMG did not comply, in all material respects, with GAAS and *Government Auditing Standards*. We also found that the Smithsonian continued to improve the quality and timeliness of the audit.

In this letter, we begin with an overview of the results of the KPMG's FY 2009 audits and then turn to our own observations, including the status of prior years' observations from our previous Oversight Letters.

In summary, we conclude that the Institution continues to make progress in improving controls, financial reporting, and the audit process; the Office of the Chief Financial Officer (OCFO) continues to take corrective actions to address outstanding recommendations from KPMG and from our office; and the OCFO continues the progress it has made in implementing its plan for strengthening internal controls, especially in the high- and medium-risk processes. At the same time, we urge the Smithsonian to further improve financial management by performing more interim testing; developing a plan for quarterly reporting; and by completing, as soon as practicable, the manuals necessary to implement internal control policies.

We set forth our scope and methodology in Attachment A.

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Federal Closing Package of the Smithsonian's Special-Purpose Financial Statements

In its independent auditors' report dated November 13, 2009, KPMG issued an unqualified opinion (the highest level of audit assurance) on the FY 2009 Federal special-purpose financial statements. KPMG reported no matters involving internal control that it considered to be material weaknesses. KPMG also reported that OC had resolved the significant deficiency that it first identified in its FY 2007 audit regarding OC's accounting resources and staff capacity.

Smithsonian Institution Financial Statements

On January 29, 2010, KPMG issued an unqualified opinion on the Smithsonian's financial statements for FY 2009 and found no matters involving internal control that it considered to be material weaknesses. KPMG did, however, identify three matters in this year's audit related to Contributions Accounting, Restricted Net Assets, and Sponsored Projects accounting. A detailed description of these matters can be found in KPMG's FY 2009 letter relating to internal controls.

Smithsonian Enterprises

For the second year, the OIG requested that KPMG perform a special-purpose audit of Smithsonian's Enterprises (SE) "net gain" used in the calculation of annual SE incentive awards and for other Institution uses.[1] With regard to the internal controls and compliance testing associated with the audit, KPMG reported one deficiency related to inventory valuation.

Smithsonian's OMB A-133 Audit of Federal Awards

The Smithsonian's OMB Circular A-133 audit process is a coordinated effort between KPMG and the Defense Contract Audit Agency (DCAA). Generally, KPMG audits the direct costs of the Smithsonian's Washington, D.C.-based activities, while DCAA audits the direct costs of the Smithsonian's Astrophysical Observatory in Cambridge, MA, as well as the indirect costs of the Smithsonian as a whole.

OMB Circular A-133 audit reports are not published until approximately 9 months after the Smithsonian's fiscal year end. As a result, current year (FY 2009) results are unavailable. However, in FY 2008, KPMG gave the Smithsonian an unqualified opinion on its Supplementary Schedules of Expenditures of Federal Awards. In addition, KPMG gave the Smithsonian an unqualified opinion on its compliance with the requirements of OMB Circular A-133. KPMG reported one finding (with questioned costs for $597,535) related to the Institution's Department of Commerce – Exhibition on Oceans program, which the Smithsonian has resolved.

[1] The audit of SE's net gain resulted from a recommendation in our audit of executive compensation at Smithsonian Business Ventures, number A-06-02 (Jan. 19, 2007), to ensure that SE's financial results are complete, accurate, and reliable for calculating incentive awards – a significant component of executive compensation – and other Institution uses.

Current Year OIG Observations on Internal Control and Financial Reporting

Contribution Accounting

In KPMG's FY 2008 report on internal controls, KPMG reported accounting for Contributions and Restricted Net Assets as significant deficiencies in the Smithsonian's financial reporting. In FY 2009, KPMG observed other matters (see *Smithsonian Institution Financial Statements* above) in both Contribution Accounting and accounting for Restricted Net Assets. OC is currently working to resolve all deficiencies and other observations related to the two accounts.

Contribution Accounting is an Institution-wide effort. Every Smithsonian unit that solicits and receives gifts, donations, pledges, or other forms of contributions, has a hand in ensuring compliance with accounting and reporting and in providing complete and accurate information to the Office of Development (OD) and subsequently to OC. The decentralized nature of the accounting is one complicating factor; others include the lack of an automated interface between OD and OC and the lack of communication and understanding with respect to the initial provisions and restrictions in the contributions, and the correct accounting treatment. Further, subsequent changes sometimes occur in the execution of a contribution, which require timely communication between OD and OC. Finally, newer forms of fundraising will put greater pressure on the Contribution Accounting processes and systems, requiring even better communication and cooperation among all the parties involved.

In January 2009, in response to recommendation 23 of the June 2007 Report of the Regents' Governance Committee, the OCFO presented to the Audit and Review Committee its *A Plan for the Strengthening Internal Controls* (the Plan), which identifies "Charitable Contributions" as a high-risk area. As noted, Contribution Accounting is complicated and decentralized and as of now, OD is not in a position to address the issues related to its high-risk status, although it is taking temporary measures to improve controls while awaiting a new system scheduled to be implemented in 2013.

Staff Resources and Capabilities

In its FY 2009 report on internal controls, KPMG reported that OC had resolved the significant deficiency that it first identified in its FY 2007 audit regarding OC's accounting resources and staff capacity. This is a significant achievement for OC and for the Institution as a whole.

Starting in FY 2008, Smithsonian management began to address serious problems in its accounting and financial reporting, especially those identified as significant deficiencies by KPMG in FYs 2006 through 2008. In FY 2008, the Smithsonian created ten new accounting positions, eight of which were funded in FY 2008 and two in FY 2009. OC filled six of the eight positions in FY 2008. In FY 2009, OC filled one position and has plans to hire two additional staff in FY 2010, in addition to the one recently brought on board. The Smithsonian felt the benefits of these new hires immediately; the number of significant deficiencies in the Institution's accounting

and reporting processes dropped to zero in FY 2009 from 11 in FY 2006 (see Table 1 on next page), 7 in FY 2007, and 3 in FY 2008. The additional hires for FY 2010 should help sustain the Institution's progress.

On a less positive note, in early FY 2010, the Deputy Comptroller resigned her position for another outside the Institution. Given the Deputy Comptroller's critical role as both a technical expert and the primary facilitator of all the parties involved in the audit, a timely and well-qualified hiring will be crucial. OC must act quickly to fill the role to ensure the gains made in coordinating the audit and improving understanding and communication among the many SI units and offices' will stabilize and continue.

Continuing Improvements in the Smithsonian's Financial Reporting and Audit Process

In our observations on last year's FY 2008 financial statement audits, we reported significant improvement in the Smithsonian's financial reporting and audit process as evidenced by (1) the status of selected financial reporting indicators and (2) improvements in qualitative factors such as planning, information, communication, and coordination.

1. *Continuing Improvement in Selected Accounting and Financial Reporting Indicators*

The following tables set forth some important indicators of the effectiveness of the Smithsonian's accounting and financial reporting process. These indicators include:

- Table 1 – number of material weaknesses, significant deficiencies, and other observations;
- Table 2 – the number of open and resolved recommendations; and
- Table 3 – the number of recorded audit adjustments and uncorrected differences.

Table 1- Smithsonian Institution Financial Statement Audit Material Weaknesses, Significant Deficiencies, and Other Observations in the Smithsonian's Accounting and Financial Reporting Process			
Year	Other Observations (Low Risk)	Significant Deficiencies (Moderate Risk)	Material Weaknesses (High Risk)
FY 2006	None	11[2]	None
FY 2007	2	7	None
FY 2008	2	3	None
FY 2009	3	None	None

[2] The 11 findings in FY 2006 consist of two reportable conditions and 9 other deficiencies. Due to a change in terminology adopted in FY 2007 the auditors now report reportable conditions, as well as other deficiencies, as significant deficiencies.

In the last four years, and for years past, KPMG has not reported any material weaknesses in the Smithsonian's financial reporting process, indicating that the Smithsonian's process is fundamentally sound, that financial information is basically reliable, and that the likelihood of a material error in its financial reports is unlikely.

As seen above, each year since FY 2006, OC has improved its accounting and reporting processes such that in FY 2009 KPMG reported no significant deficiencies. Of the 21 significant deficiencies in the three years prior to FY 2009, KPMG made 50 recommendations, primarily to improve internal controls over accounting and financial reporting. The Smithsonian has resolved 47, or 94 percent, of these recommendations.

Any unresolved deficiency demands attention because it can adversely affect the Smithsonian's ability to initiate, authorize, record, process, and report financial data consistent with the generally accepted accounting principles governing the Smithsonian's accounting and reporting.

Other observations are matters whose effect on the financial statements is inconsequential but are nevertheless worthy of attention because they point to areas where the Institution can improve its financial management.

Table 2 – Smithsonian Institution Financial Statement Audit Open and Resolved Recommendations					
Year	2006	2007	2008	2009	Total
Recommendations	23	19	8	7	57
Resolved	23	19	5	-0-[3]	47
Open	0	0	3	7	10

In FY 2009, KPMG identified three accounting issues resulting in seven recommendations for improvements in the Institution's financial reporting, a 13% drop from last year, when KPMG made 8 recommendations. OC's commitment to resolving these recommendations will advance the quality of the Institution's financial reporting.

As in our letter last year, we would like to draw your attention to OIG recommendations. These recommendations include many related to financial processes such as account reconciliations and classifications, compliance with the Institution's financial policies, regulations related to federal programs, and laws related to appropriations accounting. We are pleased to note that of the 15 outstanding OIG recommendations in these areas at the beginning of FY 2009, we closed 13 based on actions taken by the OCFO. We believe these actions, including the ones related to the remaining open recommendations, will further improve the Institution's accounting and reporting controls.[4]

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[3] Current year recommendations are not typically resolved in the year of the audit.

[4] The two remaining open recommendations relate to 1) the Administration of the Workers' Compensation Program in the Office of Human Resources and 2) certain accounting issues in the

Table 3 – Smithsonian Institution Financial Statement Audit Recorded Audit Adjustments and Uncorrected Audit Differences				
YEAR	FY 2006	FY 2007	FY 2008	FY 2009
Number of Recorded Audit Adjustments	9	15	3	None
Number of Uncorrected Audit Differences	24	31	13	12

As noted above, in FY 2009 KPMG did not propose that the Smithsonian record any audit differences, reflecting a significant improvement and stabilization in the Smithsonian's accounting and reporting process and in the completeness and accuracy of the Smithsonian's financial data.

Uncorrected audit differences (i.e., the differences between the Smithsonian's figures and KPMG's audit results that the Smithsonian chose not to record) dropped from 13 in FY 2008 to 12 in FY 2009, an 8% decrease (in FY 2006 and FY 2007, a different threshold was used, making a comparison difficult). Similar to the recorded adjustments above, the decrease in the number of uncorrected differences reflects improvement in the completeness and accuracy of the Smithsonian's financial data.

Both measures above indicate an increasing reliability in the Institution's accounting and financial reporting, one of the key goals in improving the Smithsonian's overall control structure.

We will continue to track the above indicators to measure the degree of progress in the effectiveness of the audit and in the quality of financial reporting.

2. *Continuing Improvement in Qualitative Factors*

Certain qualitative improvements took place in areas such as planning, information, communication, and coordination, as follows.

- Smithsonian operating units continued to show greater understanding, cooperation, and accountability for the audit process;
- The operating units, in most cases, and OC continued to improve the timeliness and reliability of the data they provided to KPMG, which among other things, resulted in fewer audit adjustments and uncorrected differences, as noted in Table 3 above; and
- OC and KPMG continued to work successfully to shift more audit work to an interim period to increase efficiency and improve data reliability.

On a less positive note, there were also signs that the gains in efficiency made by OC in the previous two audits might slip due to certain units having difficulty providing OC with timely and reliable information. In particular, the Office of Sponsored Projects (OSP) and the Office of Treasurer (OT) had difficulties providing the necessary financial information. These problems led to concerns that the audit report would be delayed. While all parties involved resolved the immediate problems, the underlying issues remain and need to be addressed, especially in OSP and OT. Resolving the potential for delays will be especially critical given the Deputy Comptroller's departure.

Status of Prior Years' OIG Observations on Internal Control and Financial Reporting

In our FY 2007 oversight report, we pointed to three areas that needed strengthening. Below we provide an update on each area.

1. *Improve Information and Communication between the External Auditor and the Comptroller's Office*

Overall, our concern about information and communication problems has diminished substantially. As noted earlier, KPMG and OC have a highly functioning relationship. OC and KPMG started their planning work earlier than ever. OC made every effort to produce timely and reliable documentation requested by KPMG. OC worked continuously with the operating units to obtain audit information. The recent departure of the Deputy Comptroller, however, creates some risk of a breakdown in communication and the timeliness and reliability of data, risks to which the OC will need to be attentive.

OC meetings with KPMG and operating units and support offices, such as OCIO, continued to be productive. The Office of Investments continued to produce timely and reliable information in a highly professional manner. Nearly all operating units provided KPMG with better quality and more timely information, with the notable exception of OSP and OT as discussed above.

2. *Perform More Interim Testing*

Last year, the Institution began placing more emphasis on substantive interim testing of account balances and transactions for the eight month period ending May 31. In so doing, the Institution reduced the amount of year-end testing and also reduced the time needed to resolve audit differences and other issues at year end. Further, moving some of the audit work to an earlier part of the year would reduce the impact of absences during the holiday season, a critical period of the audit. Efficiencies in interim testing still have the potential for significantly improving the timeliness of the audit.

OC continues to work with KPMG to develop and implement a plan that identifies the timing and tasks to accommodate more detailed testing of interim account balances. This year, in addition to fixed assets and federal accounts, OC provided KPMG with interim balances and documentation for contributions. Performing interim audit tests on contributions is an important part of the audit given the numerous deficiencies that KPMG has reported over the last few years and because

the interim work, in general, identifies errors, omissions, or unusual transactions that can be resolved prior to the year-end effort. Next year, for the same reasons, OC is planning to obtain interim information for Smithsonian grants and contracts.

We recommend that OC and KPMG continue to expand the use of interim testing to achieve the optimum level of efficiency in the audit.

3. *Develop a Plan for Closing Accounts and Producing Financial Statements Quarterly*

Although we understand that quarterly reporting is a long-term goal, we believe that the Smithsonian should strive to achieve that goal as soon as possible, as improvements in the current process reach a steady state. Quarterly reporting is standard practice in many organizations because it produces additional analytical data for senior management; increases the reliability of financial data; helps to make financial management more of an Institution-wide priority; and achieves greater discipline in the Institution's financial reporting process through identifying errors, omissions, unusual transactions, changes in accounting procedures, and breakdowns in controls.

We acknowledge that the cost of producing Institution-wide quarterly statements in accordance with professional accounting standards is cost-prohibitive. However, we believe that the Smithsonian can produce meaningful statements on a modified basis that would yield some of the benefits mentioned in the above paragraph. We recommend that the OCFO develop a plan for modified quarterly reporting that presents an approach for producing credible and useful quarterly financial statements.

4. *The Institution's Comprehensive Plan for Internal Controls*

In our FY 2008 report, we recommended that Smithsonian management develop a comprehensive written plan that (i) collects the various recommendations and initiatives relating to financial controls into one strategic document; (ii) prioritizes the various tasks; (iii) maps out required resources to complete each task; (iv) assigns responsibility for accomplishing each task; and (v) stipulates interim and final delivery dates. We also recommended that senior level officials closely monitor the Institution's progress in accomplishing the plan's objectives and provide regular progress reports to the Board of Regents.

The OCFO's Plan that was presented to the Audit and Review Committee last year addresses many of the elements noted in the paragraph above. As the Plan states, "For the first time, the Institution has a comprehensive view of its internal control deficiencies, the actions required to address the problem areas, and a preliminary estimate of the remediation cost."

As of September 30, 2009, the OCFO made progress in addressing the 23 processes fundamental to the Institution, with an emphasis on the five high-risk areas:

- Personal Property Management
- Procurement, Contracting and Leasing, and Purchase Card Use

- Capital Projects
- Charitable Contributions
- Use of Funds Restrictions

Among other things, OCFO has revised or has been involved in the revision of several Institution directives. These directives establish Institution-wide policies and procedures. In the last two years, the Smithsonian issued the following directives related to these high-risk areas:

- SD 314 - Contracting (issued 06/12/2008)
- SD 315 - Personal Property Management (issued 07/30/2008)
- SD 324 - Smithsonian Enterprises Retail Revenue Sharing (issued 01/26/2009)
- SD 305 - Administrative Control of Funds (issued 07/27/2009)
- SD 312 - Travel (issued 08/04/2009)
- SD 301 - Financial Management Accounting Policies and Procedures (issued 12/10/2009)
- SD 302 - Financial Management Payment Policies, Systems, and Procedures (issued 12/10/2009)
- SD 323 - Smithsonian Institution Spending Policy for Federal Appropriations and Trust Funds (issued 01/25/2010)

In some cases, the directives are accompanied by handbooks or manuals which provide detailed implementation guidance. For SD 314, Contracting, five of the seven manuals have not been issued. We urge the Institution to complete its work in this high-risk area. Further, the Smithsonian has not issued implementation guidance for SD 323, which sets forth spending policies for federal appropriations and trust funds, although it hopes to do so by mid-2010. We urge the Smithsonian to keep to this date because the topic of this guidance is an area that came to our attention during our recent audit of facilities management, where we found that the Smithsonian did not always ensure the proper use of and accounting for federal facilities maintenance funds. Finally, in addition to the above directives, we understand that SD 115, Management Controls, which was last issued in 1996, is under revision. Because it forms the basis for the Institution's overall control structure, we look forward to its prompt publication.

Apart from issuing directives, OCFO regularly sends Institution-wide e-mails on various policy updates and reminders for risk areas such as purchase cards, travel cards, and personal property accountability.

We are encouraged by the progress made on the Plan during the past year. We believe the design of the above policies and procedures and the related implementation in various Smithsonian offices and units reflects progress in establishing an effective control structure at the Institution.

As stated in our FY 2008 letter, our office will monitor the implementation and operating effectiveness of this Plan, conducting audits as we deem appropriate. Areas of audit may include status of the Plan implementation and stated milestones;

implementation costs; the competence of assigned staff; design of controls and operating effectiveness; and direction and leadership.

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We sincerely appreciate the professionalism of KPMG's staff and the cooperation and dedication of staff in the Office of the Chief Financial Officer.

Very truly yours,

A. Sprightley Ryan
Inspector General

cc Chair, Board of Regents
Under Secretary for Finance and Administration
Chief Financial Officer
Comptroller

Attachment A

Scope and Methodology

The scope of our oversight review included KPMG's FY 2009 audits of the Institution's special-purpose federal financial statements, the Smithsonian-wide financial statements, SE's special-purpose statement of net gain, as well as the OMB A-133 audit for FY 2008.

We reviewed (i) planning documents, including risk assessments, materiality calculations, audit programs, internal control evaluations, and sampling plans; (ii) test results of detailed transaction testing; (iii) other selected work papers; and (iv) financial reporting procedures. In addition, we held discussions with KPMG auditors and managers, representatives from the Office of the Chief Financial Officer and support offices, and officials from Smithsonian Enterprises. For the OMB A-133 audit, we reviewed the workpapers and report and discussed the audit results with KPMG.

We performed our oversight review from July 2009 to March 2010 and designed our procedures to comply in all material respects with the audit program and guidance developed by the Council of Inspectors General on Integrity and Efficiency for OIG oversight of independent public accountants.

We provided KPMG and the CFO with a draft of this report. Based on their comments, we made changes to the report to the extent we deemed appropriate.