Smithsonian Institution
Office of the Inspector General

Memo

Date: January 10, 2018

To: David M. Rubenstein, Chair, Board of Regents
John W. McCarter, Jr., Chair, Audit and Review Committee, Board of Regents
Dr. David J. Skorton, Secretary

Cc: Albert G. Horvath, Under Secretary for Finance and Administration and Chief Financial Officer
John Benton, Deputy Under Secretary for Finance and Administration
Dennis Kelly, Acting President, Smithsonian Enterprises
Beth Cunigan, Controller, Smithsonian Enterprises
Jean Garvin, Director, Office of Finance and Accounting
Greg Bettwy, Chief of Staff, Office of the Secretary
Porter Wilkinson, Chief of Staff to the Board of Regents

Cathy L Helm

From: Cathy L. Helm, Inspector General

Subject: Independent Accountant's Report on the Smithsonian Enterprises Net Gain for Fiscal Year 2017 (OIG-A-18-03)

This memorandum transmits the results of the Smithsonian Enterprise's Net Gain review for fiscal year 2017 performed by the independent public accounting firm of KPMG LLP (KPMG).[1] On January 10, 2018, KPMG issued its independent accountants' report on the Smithsonian Enterprises Statement of Net Gain, as of September 30, 2017. KPMG concluded that no material modifications should be made to the Statement of Net Gain to be in accordance with U.S. Generally Accepted Accounting Principles.

As part of our oversight activities, we reviewed KPMG's report and documentation and interviewed its representatives. Our review of KPMG's fiscal year 2017 work disclosed no instances where KPMG did not comply, in all material respects, with the American Institute of Certified Public Accountants' Statement on Standards for Accounting and Review Services.

If you have any questions, please do not hesitate to contact me or Joan T. Mockeridge, Assistant Inspector General for Audits, at (202) 633-7050.

Attachment

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[1] The Office of the Inspector General is the Contracting Officer's Technical Representative for the oversight of KPMG's work.

SMITHSONIAN ENTERPRISES

Statement of Net Gain

For the year ended September 30, 2017

(With Independent Accountants' Review Report Thereon)

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Accountants' Review Report

Office of the Inspector General,
Audit and Review Committee of the Board of Regents, and Secretary Skorton
Smithsonian Institution:

We have reviewed the accompanying statement of net gain (as described in note 2), the notes to the statement of net gain and the supplemental schedule of net gain by lines of business of Smithsonian Enterprises, an unincorporated operating division of the Smithsonian Institution, for the year ended September 30, 2017. A review includes primarily applying analytical procedures to management's financial data and making inquiries of management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the statement of net gain as a whole. Accordingly, we do not express such an opinion.

As discussed in note 1, Smithsonian Enterprises is an unincorporated operating division of the Smithsonian Institution. The accompanying statement of net gain may not be indicative of the net gain that would have been achieved if Smithsonian Enterprises was an unaffiliated entity.

Management's Responsibility for the Statement of Net Gain

Management is responsible for the preparation and fair presentation of the statement of net gain in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the statement of net gain that is free from material misstatement, whether due to fraud or error.

Accountants' Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the statement of net gain for it to be in accordance with U.S. generally accepted accounting principles. We believe that the results of our procedures provide a reasonable basis for our conclusion.

Accountants' Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying statement of net gain in order for it to be in accordance with U.S. generally accepted accounting principles.

KPMG LLP

January 9, 2018

KPMG LLP is a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

SMITHSONIAN ENTERPRISES

Statement of Net Gain

For the year ended September 30, 2017

(Dollars in thousands)

Operating revenues, net:		
Merchandise sales	$	74,311
Media		44,292
Concessions, licensing, and other		60,223
Total operating revenues, net		178,826
Operating expenses:		
Cost of goods sold		34,539
Production costs		16,215
Circulation costs		12,585
Selling, general, and administrative costs		65,877
Depreciation and amortization		4,130
Total operating expenses		133,346
Net gain before increase in investment in Smithsonian Channel		45,480
Increase in investment in Smithsonian Channel		2,232
Net gain		47,712
Add back: Net loss on new strategic business initiatives		768
Net gain excluding new strategic business initiatives	$	48,480

See accompanying notes to the statement of net gain and accountants' review report.

SMITHSONIAN ENTERPRISES

Notes to Statement of Net Gain

September 30, 2017

(Dollars in thousands)

(1) Organization

Smithsonian Enterprises (SE) was established as an unincorporated operating division within the Smithsonian Institution (Smithsonian) in August 1999. Smithsonian was created by an act of Congress in 1846 in accordance with the terms of the will of James Smithson of England, who in 1826 bequeathed property to the United States of America “to found at Washington, under the name of the Smithsonian Institution, an establishment for the increase and diffusion of knowledge among men.” Congress established the Smithsonian as a trust of the United States of America and vested responsibility for its administration in the Smithsonian Board of Regents.

SE consists of various revenue producing business activities such as magazine publications, theater sales, museum stores and concessions, mail-order catalogs, product development and licensing, and supporting offices.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

Net gain is an operating measure used by management of Smithsonian and SE to assess the operating results of SE. Net gain includes all revenues and expenses related to SE’s business activities, including certain expenses allocated to SE by Smithsonian.

The statement of net gain is presented using the accrual basis of accounting. The year presented in the statement of net gain and the supporting schedule of net gain by lines of business is from September 25, 2016 through September 30, 2017 (Fiscal Year 2017). SE’s accounting year ends on the last Saturday of September.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Smithsonian agreed to invest in certain new strategic business initiatives and to exclude them from SE financial management reporting. During Fiscal Year 2017, such investments increased net gain by $768.

(b) Revenue Recognition

Revenues from magazine subscriptions are deferred and recognized ratably over the subscription period. Revenues from magazine retail sales are recognized as revenue, net of estimated returns, when publications are on sale. Revenue from advertising is recognized, net of agency commissions and discounts, when publications are on sale.

Revenue from the sale of merchandise is recognized at the time merchandise is sold, net of anticipated returns. Revenue from the sale of merchandise to be sent to customers is recognized when products are shipped.

Guaranteed revenues from concessions agreements are recognized ratably based on the terms of the agreement. Revenues in excess of minimum guarantees are recognized when sales are reported by concessions vendors.

Guaranteed revenues from licensing agreements are recognized upon delivery and acceptance by the distributor. Royalties in excess of minimum guarantees are recognized when sales are reported by third-party distributors.

Amounts received from customers in advance of revenue recognition are deferred and included in the deferred revenues account.

SE accounts for its investment in the Smithsonian Channel on the equity method. During Fiscal Year 2017, SE recognized $2,232 attributable to the increase in the net assets of this investment.

(c) Deferred Revenues and Expense Recognition

Revenues from subscriptions to *Smithsonian* and *Air and Space* magazines are deferred and recognized ratably over the period of the subscription, generally one year.

Promotion production expenses are recognized when related advertising materials are released. Direct-response advertising relating to the magazines is deferred and amortized over the period during which future benefits are expected to be received, generally 7 to 14 months. Advertising expense, including direct-response advertising of $8,244, amounted to $13,027 for Fiscal Year 2017, and is included in production, circulation, and selling, general and administrative costs.

(d) Inventories

Inventories are reported at the lower of cost or market, and consist primarily of merchandise and books. Cost is determined using the weighted average method.

(e) Property and Equipment

Property and equipment owned by Smithsonian and used by SE in its operations are allocated to SE and stated at cost. These assets are depreciated on a straight-line basis over their estimated useful lives as follows:

Buildings and improvements	30 years
Major renovations	15 years
Equipment and software	3-10 years

Leasehold improvements are amortized over the shorter of the Smithsonian lease term or their useful lives.

(f) Shipping and Handling Fees and Costs

Shipping and handling fees of $1,541 billed to customers are included in merchandise sales. Shipping and handling cost associated with inbound freight are included in cost of goods sold. Shipping and handling costs associated with outbound freight of $775 not billed to customers are included in selling, general and administrative costs.

(g) Income Taxes

Smithsonian is recognized as exempt from income taxation under the provisions of Section 501(c) (3) of the Internal Revenue Code. Organizations described in that section are taxable only on their unrelated business income. SE's advertising sales are Smithsonian's principal source of unrelated business income.

Smithsonian recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. SE does not believe the statement of net gain includes any uncertain tax positions.

(3) Employee Benefit Plans

Substantially all SE employees are eligible to participate in the Smithsonian's defined-contribution retirement plan. Under the plan, Smithsonian contributes specified percentages of employees' salaries to purchase individual annuities, the rights to which are immediately vested with the employees. Employees can make voluntary contributions, subject to certain limitations. During Fiscal Year 2017, SE's contribution expense under this plan amounted to $3,243.

(4) Commitments and Contingencies

(a) Food Services Agreement

SE, through Smithsonian, has an agreement, beginning in Fiscal Year 2016 through March 2026, with a third-party to assist in the design, construction, and operation of food services at several Smithsonian museums. In Fiscal Year 2016, the third party provided $7,200 in capital improvement funding of design and construction costs for the Food & Beverage Operations in the museums at the discretion of Smithsonian that is being recognized over the ten-year term of the agreement. Provisions in the agreement allow for the repayment of the design and construction costs based on the passage of time, should the agreement be terminated. Commission revenue of $7,899 under this agreement was recognized during Fiscal Year 2017.

In Fiscal Year 2016, the same third-party paid SE $1,000 for certain marketing rights which is also recognized ratably over the ten-year term of the agreement.

(b) Outsourcing Agreements

Under an agreement expiring in July 2018, SE engaged a third-party to provide infrastructure, transaction management services and systems support for its catalog business. Fees are established based upon services performed and amounted to $1,360 during Fiscal Year 2017. Such fees are included in selling, general, and administrative costs.

Under a contract expiring in December 2019, SE engaged a third-party to provide fulfillment services for its magazine circulation. Fees are based upon the quantity of circulation and amounted to $1,871 during Fiscal Year 2017. Such fees are included in circulation costs.

Under a contract expiring in October 2022, SE engaged a third-party to operate a distribution center for all merchandise sold in SE museum stores. Fees vary based on the actual functions and transactions completed by the vendor and amounted to $935 during Fiscal Year 2017. Such fees are included in selling, general, and administrative costs.

(5) Subsequent event

In November 2017, SE sold a portion of its investment in the Smithsonian Channel to its partner (Showtime Networks Inc.) for $24,600 recognizing a gain of $12,772 on the sale and reducing its ownership to 15%.

Supplemental Schedule

SMITHSONIAN ENTERPRISES

Schedule of Net Gain by Lines of Business

Year ended September 30, 2017

(Dollars in thousands)

	Museum Services	Retail / Direct	Media	Consumer & Education Products	Corporate	New Strategic Business Initiatives	Total	Total excluding New Strategic Business Initiatives
Operating revenues, net:								
Merchandise sales	$ —	71,248	3,017	—	—	46	74,311	74,265
Media	—	34	44,167	—	—	91	44,292	44,201
Concessions, licensing, and other	20,770	15,713	9,025	14,136	476	103	60,223	60,120
Total operating revenues, net	20,770	86,995	56,209	14,136	476	240	178,826	178,586
Operating expenses:								
Cost of goods sold	—	29,963	1,471	2,992	—	113	34,539	34,426
Production costs	—	3,027	12,568	322	—	298	16,215	15,917
Circulation costs	—	169	11,731	678	—	7	12,585	12,578
Selling, general, and administrative costs	2,854	27,717	21,386	4,651	8,733	536	65,877	65,341
Depreciation and amortization	1,310	1,195	356	1	1,214	54	4,130	4,076
Total operating expenses	4,164	62,071	47,512	8,644	9,947	1,008	133,346	132,338
Net gain (loss) before increase in investment in Smithsonian Channel	16,606	24,924	8,697	5,492	(9,471)	(768)	45,480	46,248
Increase in investment in Smithsonian Channel	—	—	2,232	—	—	—	2,232	2,232
Net gain (loss)	$ 16,606	24,924	10,929	5,492	(9,471)	(768)	47,712	48,480