Smithsonian Institution

Office of the Inspector General

March 31, 2008

Audit and Review Committee
Board of Regents
Smithsonian Institution
Washington, D.C. 20560

Dear Members of the Audit and Review Committee:

In Fiscal Year 2007, the Office of the Inspector General served as the Smithsonian's Contracting Officer's Technical Representative to provide audit quality oversight of the Smithsonian's independent certified public accounting firm, KPMG LLP. This letter presents our observations on the FY 2007 audit process for the Federal Closing Package and the Annual Financial Statement Audit, and includes comments on improving the process for the FY 2008 audit cycle and beyond. We also briefly summarize the audit of the Smithsonian's federal awards, which was performed in accordance with U.S. Office of Management and Budget Circular A-133.

Our review, as differentiated from KPMG's audits, which were conducted in accordance with the American Institute of Certified Public Accountants' (AICPA) generally accepted auditing standards 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 AICPA generally accepted auditing standards and *Government Auditing Standards*. However, we believe KPMG and the Smithsonian could improve the audit process. We begin with a brief summary of significant findings from the FY 2007 audit engagements and then turn to our own observations.

We also make one recommendation: that Smithsonian management develop a comprehensive plan of action to address all deficiencies KPMG has identified as well as all recommendations from this office and those resulting from the Institution's ongoing governance reform efforts.

Our scope and methodology is included in Attachment A.

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

On November 15, 2007, KPMG issued an unqualified opinion on the FY 2007 Federal special-purpose financial statements. KPMG found no matters involving internal control that it considered to be material weaknesses. Additionally, KPMG indicated that the Chief Financial Officer (CFO) implemented sufficient actions to resolve the two reportable conditions from last year's independent auditors' report on the Smithsonian's special-purpose financial statements associated with Federal Employment Compensation Act liabilities and post-retirement benefit costs.

However, KPMG reported a significant deficiency in internal control over financial reporting regarding the Office of the Comptroller's (OC) accounting resources and staff capacity. As KPMG noted, this issue is a continuation of a reportable condition KPMG identified in last year's management letter on its audit of the Smithsonian's financial statements. As a result of the resource shortage, closing the federal general ledger was delayed for two weeks. Moreover, OC's inability to provide sufficient supervisory review of journal entries, account reconciliations, and supporting schedules led to several significant accounting errors and inconsistencies in the preparation of the special-purpose financial statements.

KPMG recommended that the CFO and other appropriate members of the Smithsonian's financial management team continue to focus on the accounting resource needs and staff capacity in OC during FY 2008 and consider reorganization where necessary to ensure that appropriate supervisory depth is in place and that resources are adequate to meet the organizations requirements. The CFO agreed that accounting resources and staff capacity in OC are strained and indicated that efforts are continuing to rebuild OC supervisory and other staff.

Smithsonian Institution Financial Statements

On February 15, 2008, KPMG issued an unqualified opinion on the Smithsonian's financial statements for FY 2007 and found no matters involving internal control that it considered to be material weaknesses. However, KPMG identified seven significant deficiencies:

- <u>Accounting Resources and Staff Capacity.</u> The Smithsonian's accounting and financial reporting processes for FY 2007 were insufficient to identify and detect all misstatements that were more than inconsequential to the financial statements. KPMG identified numerous adjustments that management recorded in the financial statements as well as a number of unadjusted audit differences. KPMG noted that compared to FY 2006, OC accounting personnel resources had deteriorated further.

- <u>Lease Accounting.</u> KPMG identified several significant audit differences required to properly report tenant improvement allowances as well a several other errors in the accounting for leases that amounted to over $12 million. Smithsonian units were typically negotiating the terms of lease agreements with limited or no input from the OC as to any accounting implications of the proposed agreement terms.

- Contribution Accounting. KPMG noted several instances where insufficient communications between the Office of Development (OD) and OC resulted in misstatements in the FY 2007 accounting records. For instance, the present value discount calculation to reflect significant changes in the timing of expected payments to be made on a pledge required an adjustment of $6 million to record an additional discount at September 30, 2007. KPMG also noted that procedures for calculating appropriate reserve estimates for contributions receivable needed improvement. KPMG proposed an audit adjustment to increase the reserve against specific pledges by nearly $3 million, but management did not record the proposed adjustment.

- Account Reconciliation. Reconciliations performed by OC did not resolve unreconciled payroll account activity, among other account reconciliation problems, resulting in a $2 million audit adjustment.

- Financial Statement Presentation of Donor Restrictions. The process used by the Smithsonian to track donor-restricted funding is a complicated, manual, multi-office process that is prone to error. KPMG identified mistakes in beginning balances, audit differences, and other accounting problems that ranged from $3.8 million to over $12 million. In addition, disclosures in the Smithsonian's financial statements did not include required information on the nature and amounts of temporarily and permanently restricted net assets or the nature of the temporary restrictions that are satisfied during the year.

- Reporting of Grant Revenue and Receivables. KPMG noted that although the Office of Sponsored Projects regularly reconciles revenues and receivable balances for all grant activity, management did not ensure that a complete reconciliation of the entire temporarily restricted net asset balance based on prior-year starting balances and all current year activities was performed. KPMG identified errors and unexpected reconciling items in the temporarily restricted net asset balances. KPMG proposed adjustments of $2 million and $4.8 million to correct the accounts (management did not record the $4.8 million adjustment).

- Investments Held by Trustees. KPMG noted that the Smithsonian did not have current information relating to all its investments held in one trust and that it only had limited "visibility" or information on the non-marketable investment assets of two other trusts valued at $13.5 million as of September 30, 2007.

- Other Weaknesses. While KPMG noted that the Smithsonian significantly enhanced how it monitors the valuations of non-marketable investments, KPMG also noted that the Institution needs to improve documentation and review procedures to address year-end valuation procedures, assessment of incentive fees, and the development and use of risk ratings to better align oversight procedures and resources with assessed risk levels. The Institution also needs to refine the methodology and application of certain expense allocations as well as to perform a coordinated analysis and prepare documentation of tax positions to satisfy new accounting standards.

Although the number of FY 2007 uncorrected audit differences increased from FY 2006, the dollar impact on net assets was substantially less. Similarly, recorded adjustments, which amounted to nearly $140 million in FY 2006, decreased to $57 million in FY 2007. Further, the associated impact of the adjustments on net assets improved from an aggregate decrease of about $94 million to an increase of a little more than $2 million. See the chart below for more details (dollar amounts are in millions).

Year	Uncorrected Audit Differences	Impact on Net Assets (+ or -)	Recorded Audit Adjustments	Impact on Net Assets (+ or -)
	Number	Amount	Number	Amount
FY 2007	31	$4.9 -	15	$2.3 +
FY 2006	24	$38.0 -	9	$93.8 -

KPMG's Management Letter accompanying its opinion on the Smithsonian's FY 2007 financial statements contained 19 recommendations to correct these deficiencies. Smithsonian management agreed to take corrective actions on all recommendations. We noted that KPMG does not typically track individual recommendations or require estimated completion dates for management's corrective actions. Accordingly, while management agreed to complete a few of the corrective actions in FY 2008, it did not provide specific milestones for many of the needed actions.

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. 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 nearly 9 months after the Smithsonian's fiscal year end due to DCAA's timetable for completing its part of the audit. As a result, current year results are not yet available. However, in FY 2006, KPMG gave the Smithsonian an unqualified opinion on its Supplementary Schedules of Expenditures of Federal Awards. In addition, the Smithsonian received an unqualified opinion on its compliance with the requirements of OMB Circular A-133 for each of its major programs. The external auditors identified one reportable condition regarding controls over the recording of award costs prior to goods and services being received.

DCAA gave the Smithsonian a qualified opinion pending the receipt of certain assist audit results. Assist audits are audits of subcontractor costs (i.e., subcontractors to the Smithsonian's primary contractors) done by cognizant DCAA offices. Audits of subcontractor's costs in the amount of $9,504,333 had not yet been received as of June 30, 2007, the date of the FY 2006 A-133 report.

Prior-year findings and recommendations from the A-133 audit included the need to: (i) improve leave allocation procedures for employees who expend time on more than one project; (ii) enhance procedures over disbursements to ensure costs are adequately documented; and (iii) strengthen procedures over purchase order close-out to ensure that amounts are not recorded as federal expenditures and requested for reimbursement until goods and services have been received. In addition, the audits identified small amounts of unallowable costs that were over-billed to NASA. According to the Comptroller, the Smithsonian has taken, or will take, appropriate corrective actions on all of the recommendations, although target dates for completing all actions were not provided.

OIG Observations

In our letter report last year, we discussed three areas that needed strengthening. The Institution made notable improvements this year, but has considerably more work ahead to enhance the Institution's accounting and auditing processes.

- Improve Communications between the External Auditor and the Comptroller's Office

KPMG and OC made significant improvements in this area. Based on our observations and discussions with Smithsonian officials, KPMG's meetings with the support offices (operating units) were more constructive and included more individuals responsible for providing supporting analyses and documentation. KPMG's use of the "Prepared by Client" list was more effective in managing the audit than in prior years. Setting up-front deadlines for Smithsonian staff to provide documentation was especially valuable. Moreover, unlike last year, there were no surprise audit findings or management letter comments, indicating better communications with Smithsonian officials throughout the audit.

To its credit, OC held numerous meetings with Smithsonian support offices to ensure a better understanding of the content and timing of KPMG's data requests. Management officials from these offices devoted more time and effort to the process, resulting in some improvements in the reliability and timeliness of the supporting data. Overall, the Comptroller and Smithsonian staffs were engaged during the audit process and addressed KPMG's requests in a timelier manner.

The above improvements notwithstanding, KPMG and the Smithsonian must continue to strengthen the audit process. KPMG needs to ensure that OC and support office staffs fully understand the extent of the documentation needs for any given request and the potential for continuing follow-up and requests for additional information. OC and the support offices need to provide more accurate and complete documentation for general ledger accounts, reconciliations, and supporting analyses. The Comptroller also needs to provide effective training to OC staff and Smithsonian units so that accounts can be closed more timely and with fewer adjustments.

- Perform More Robust Interim Testing

To enhance the efficiency and effectiveness of the annual financial statement audit, more focus should be placed on substantive interim testing of account balances and transactions. Doing so will reduce the amount of year-end testing and the time needed to resolve audit differences and other issues. We encouraged the Chief Financial Officer to work closely with KPMG to develop and implement a plan that identifies the timing and tasks to accommodate more detailed testing of interim account balances.

In FY 2007, KPMG and OC initiated discussions and planning to resolve this issue but made little progress due to the Smithsonian's accounting resource constraints.

- Develop a Plan for Closing Accounts and Producing Financial Statements Quarterly

For the external auditor to perform substantive interim testing, the Smithsonian needs to produce interim account closings. According to the Chief Financial Officer, the Smithsonian currently does not have the requisite systems or staff resources to routinely perform interim account closings and produce quarterly financial statements. Getting better and more frequent accounting data from the support offices will require staffing and procedural changes.

In the short term, the Chief Financial Officer has identified 10 new accounting positions to help strengthen the accounting and reporting process. Five of these positions will be located in the units that typically have the most difficulty reporting timely, accurate financial statement information and have a material impact on the Institution's financial statements. In addition, the Comptroller has undertaken a top-to-bottom review of all general ledger balances, which includes visits to Smithsonian support offices, training, eliminating duplicate and inactive accounts, identifying process improvements, resolving unusual balances and transactions, and conducting account reconciliations.

In the longer term, the Smithsonian needs to commit adequate resources for systems development and support as well as financial staff to be able to produce timely, credible quarterly financial statements and to designate as many accounts as is practicable for interim closing (June 30).

The Institution Needs a Comprehensive Plan

In our view, the Smithsonian must develop a comprehensive plan to address the deficiencies in its accounting and reporting processes that KPMG, this office, and the Regent's Governance Committee have identified over the last few years.

While the Smithsonian made some improvements in FY 2007, particularly in investment valuation and Smithsonian Business Ventures' accounting procedures, KPMG reported that OC's accounting personnel resources continued to deteriorate. KPMG noted that overall the Smithsonian's accounting and financial reporting processes for FY 2007 were insufficient to identify and detect all misstatements that were more than inconsequential to its financial statements.

KPMG made 19 new recommendations for strengthening the Institution's accounting and reporting controls. Moreover, OC has not fully implemented actions to resolve 12 of the 23 recommendations made by KPMG in last year's audit. In its response to the 19 current audit recommendations, OC did not provide completion dates for the majority of the needed corrective actions.

The chart below shows the status of KPMG's recommendations related to its financial statement audits for the last 2 years.

YEAR	KPMG RECOMMENDATIONS	RESOLVED[1]	IN PROCESS
FY 2007	19	_	19
FY 2006	23	11	12
Totals	42	11	31

In addition to KPMG's recommendations, there are three open OIG recommendations on which OC has not taken sufficient action. These recommendations, related to the lack of policies and procedures in cash management and banking activities, have remained open for more than two years, and OC has recently indicated that it will not complete corrective actions until mid-2009. According to the Comptroller, the primary reason for the delay is the assignment of the Office of the Chief Information Officer (OCIO) staff to the PeopleSoft upgrade and the lack of OCIO resources to address all priorities more timely. In our opinion, delays in implementing the needed improvements increase the risk that significant accounting and financial reporting errors will continue to occur and not be detected in a timely manner.

The Institution must also address the recent recommendations from the Independent Review Committee and the Board of Regents' Governance Committee. These recommendations directed the Chief Financial Officer to conduct periodic examinations of senior executive entertainment expenses, review the Smithsonian federal and trust budget formulation and monitoring process, and assess the Smithsonian's financial reporting systems and internal controls to ensure the appropriate systems and controls are in place to enable the Committee and the Board to provide meaningful oversight of the accuracy and integrity of Smithsonian financial statements and reports. Accomplishing these tasks in a thorough and timely manner will require an integrated plan supplemented by substantial resources with commensurate accounting and financial expertise.

Accordingly, we recommend that Smithsonian management develop a comprehensive written plan that (i) collects the various recommendations and initiatives into one strategic document; (ii) prioritizes the various tasks; (iii) maps out required resources to

[1] In addition to the 11 resolved recommendations, KPMG indicated that the Smithsonian made significant efforts on the valuation of alternative investments that resulted in substantial resolution of the six recommendations associated with last year's reportable condition.

complete each task; (iv) assigns responsibility for accomplishing each task; and (v) stipulates interim and final delivery dates. Senior level officials should closely monitor the Institution's progress in accomplishing the plan's objectives and provide regular progress reports to the Board of Regents.

Finally, we note that the schedule for completing the annual financial statement audit should be shortened to provide more useful and timely financial reporting. The former Secretary required the audited financial statements to be completed by December 15th, in part to publish audited figures in the Smithsonian's Annual Reports, as well as to provide timely information to the Board of Regents. We note that the FY 2006 audited statements were completed on February 20, 2007, 143 days after the fiscal year end. For the most recent audit, the audited statements were released February 15, 2008, a 5-day improvement from the prior year.

Given the limitations of current accounting and reporting systems as well as the lack of accounting personnel, it is unrealistic to expect completed audited statements substantially earlier in the near term. In addition, accounting and auditing standards for alternative investments require significantly more documentation and analysis than in the past and alternative investments have become an increasingly larger portion of the Smithsonian's portfolio. Nevertheless, the Smithsonian should strive to issue the audited statements in time for the Board of Regents' winter meeting, which usually takes place in late January. This also will more closely align the Institution with best practices in the non-profit sector.

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We sincerely appreciate the professionalism and quality of KPMG's staff that conducted the FY 2007 audit and the cooperation and dedication of staff in the Office of the Chief Financial Officer.

Very truly yours,

A. Sprightley Ryan
Inspector General

Attachment A

Scope and Methodology

The scope of our oversight review included KPMG's audits of the special-purpose federal financial statements and the Smithsonian-wide financial statements for FY 2007, as well as the OMB A-133 audit for FY 2006.

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 Business Ventures. For the OMB A-133 audit, we reviewed the work papers and report and discussed the audit results with KPMG.

We performed our oversight review from July 2007 to March 2008 and designed our procedures to comply in all material respects with the audit program developed by the President's Council 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.