



# Smithsonian Institution

Office of the Inspector General

March 5, 2009

Audit and Review Committee  
Board of Regents  
Smithsonian Institution  
Washington, D.C. 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 2008 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, and contains suggestions for improving the process for the FY 2009 audit cycle and beyond. We also summarize KPMG's FY 2007 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 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; of particular note, KPMG was able to issue its Independent Auditors' Report on the Smithsonian's financial statement audit two weeks earlier than the previous year. We further found that the OC resolved a significant number of prior year recommendations, improving the efficiency and overall effectiveness of the audit.

In this letter, we begin with an overview of significant findings from KPMG's FY 2008 audits and then turn to our own observations. In our FY 2007 letter, we made one recommendation that Smithsonian management develop a comprehensive plan of action to address the deficiencies KPMG has identified as well as all recommendations from this office and those resulting from the Institution's ongoing governance reform efforts.

In summary, we conclude that the Institution has made significant progress in improving the audit process, progress that it must sustain; the Office of the Chief Financial Officer still needs to take corrective actions to address outstanding recommendations from KPMG and from our office; and the Institution should act decisively to implement the OCFO's plan for strengthening internal controls.

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 17, 2008, KPMG issued an unqualified opinion (the highest level of audit assurance) on the FY 2008 Federal special-purpose financial statements. KPMG reported no matters involving internal control that it considered to be material weaknesses. KPMG did report a significant deficiency in internal control over financial reporting regarding OC's accounting resources and staff capacity, a condition KPMG had also identified in its 2007 audit.

As it has over the last two years, 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 fiscal year 2009. In response, the Chief Financial Officer and the Comptroller agreed to continue their efforts to review work assignments, reorganize where necessary, provide required training, and address the level of review and supervision of activities to improve the preparation of financial statements. In FY 2008, Smithsonian management created ten new accounting positions, two of which were unfunded until FY 2009. OC filled six of the eight funded positions in FY 2008. The benefits of these six new hires will increase as their knowledge and experience with the Smithsonian grows; the remaining four hires (two authorized in FY 2008 and 2 in FY 2009) will also add significant support for the audit.

### Smithsonian Institution Financial Statements

On January 30, 2009, KPMG issued an unqualified opinion on the Smithsonian's financial statements for FY 2008 and found no matters involving internal control that it considered to be material weaknesses. KPMG did identify three significant deficiencies:

- Lack of a formal evaluation process for certain contribution transactions;
- Dependence on manual processes in accounting for construction activities; and
- Incomplete accounting for restricted net assets.

A detailed description of these deficiencies can be found in KPMG's FY 2008 letter relating to internal controls. KPMG recommended that the Smithsonian:

- Implement procedures to require documentation of accounting considerations and conclusions when there are changes in the key terms of significant pledge agreements, including both gift and endowment transactions;
- Enhance the review of contribution and gift transactions to ensure appropriate entries are recorded in both the development and financial records;
- Review its accounting processes for construction activities to reduce the manual inputs involved;
- Revise its year-end closing process to require construction project managers to obtain and provide year-end estimates of work performed but not yet invoiced so that the Smithsonian can ensure a complete and accurate accrual for construction costs; and
- Continue to refine the processes and methodologies in place for capturing and analyzing temporarily restricted net asset accounts for facilities.

Smithsonian management agreed to take corrective actions on all recommendations, but did not provide estimated completion dates. Accordingly, while management agreed to complete the FY 2008 corrective actions, it did not agree to any specific milestones.

As part of this year's audit services, 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.<sup>1</sup> Because KPMG was not engaged to perform the audit of SE's net gain until after September 29, 2007, they were not present to observe the physical inventory counts during fiscal year 2007. Except for the effects of any adjustments that might have been necessary had KPMG been present to observe the opening inventory (which enters into the determination of cost of goods sold and net gain), KPMG concluded that SE presented fairly, in all material respects, its net gain for the period ended September 27, 2008.

With regard to the internal controls and compliance testing associated with the audit, KPMG reported three significant deficiencies related to:

- Systems access and segregation of duties;
- Inventory and sales return reserves; and
- Deferred promotion costs.

SE management has implemented or plans to implement corrective actions that will resolve these deficiencies.

#### *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 results are unavailable. However, in FY 2007, 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 \$31,000) related to the Institution's Research and Development program, which the Smithsonian has since resolved.

DCAA also gave the Smithsonian an unqualified opinion on its Compliance with the Requirements Applicable to Major Programs and on Internal Control Over

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<sup>1</sup> 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.

Compliance in Accordance with OMB Circular A-133. DCAA identified three findings related to the Smithsonian's Federal Awards, two of which have been resolved.

### Current Year OIG Comments and Observations

Our observations on the FY 2008 financial statement audits focus on two areas:

- Improvements in the Smithsonian's financial reporting and audit process; and
- The status of certain financial reporting indicators.

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

We are pleased to report significant improvements in the financial reporting and audit process. Most notably, KPMG was able to issue the audit report on the Smithsonian's financial statements two weeks earlier than the FY 2007 report. This improvement reflects, among other things:

- Certain Smithsonian operating units demonstrated greater understanding of and cooperation with the audit process;
- The operating units and the Office of the Comptroller (OC) improved the timeliness and reliability of the data they provided to KPMG, which among other things, resulted in fewer audit adjustments and uncorrected differences;
- OC provided KPMG with a draft set of financial statements with fewer errors in presentation and disclosure, thus reducing the time spent by KPMG in the final stages of the audit;
- OC resolved a significant number of outstanding recommendations related to prior-year deficiencies; and
- OC added six new staff members to support the audit.

### Financial Reporting Indicators

The following tables set forth what we believe are important indicators of the effectiveness of the Smithsonian's accounting and financial reporting process: material weaknesses, significant deficiencies, and other observations; open and resolved recommendations; and 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 2008	2	3	None
FY 2007	2	7	None
FY 2006	-0-	11 <sup>2</sup>	None
<b>Total</b>	<b>4</b>	<b>21</b>	<b>None</b>

In the last three 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.

KPMG has reported 21 significant deficiencies over the past three years in the Smithsonian's accounting and reporting processes. Each year has seen a drop in the number of deficiencies such that in FY 2008 KPMG reported only three, a 57% decrease from FY 2007.

Nevertheless, any significant 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 matters worthy of attention.

Table 2 – Smithsonian Institution Financial Statement Audit				
Open and Resolved Recommendations				
Year	2006	2007	2008	Total
Recommendations	23	19	8	50
Resolved	20	13	-0- <sup>3</sup>	33
Open	3	6	8	17

<sup>2</sup> The 11 findings in FY 2006 consist of two reportable conditions and 9 other deficiencies. Due to a terminology change in FY 2007, reportable conditions, as well as other deficiencies, have now generally been categorized under the term significant deficiencies.

<sup>3</sup> Current year recommendations are not typically resolved in the year of the audit.

In FY 2008, KPMG made eight recommendations for improvements in the Institution's financial reporting process. This was a 58% drop from last year, when KPMG made 19 recommendations. To date, OC has resolved 33, or 79%, of the 42 total recommendations from FYs 2006 and 2007. OC's resolution of these recommendations reflects growing improvement in the quality of the Institution's financial reporting.

As in our letter last year, we would like to draw your attention to OIG recommendations related to financial processes. While we recently closed two of our recommendations related to cash management and banking activities, five of our recommendations remain open relating to travel oversight. We are pleased that the OCFO has agreed to resolve the OIG recommendations in FY 2009, which we believe will further bolster the effectiveness of the accounting and reporting process.

Table 3 – Smithsonian Institution Financial Statement Audit			
Recorded Audit Adjustments and Uncorrected Audit Differences			
YEAR	FY 2006	FY 2007	FY 2008
Number of Recorded Audit Adjustments	9	15	3
Number of Uncorrected Audit Differences	24	31	13

As noted above, in FY 2008, the number of recorded KPMG audit adjustments dropped from 15 to 3, an 80% decrease. The net dollar impact of the FY 2008 adjustments on net assets was zero. The reduction in the number of audit adjustments signals a significant improvement 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 31 in FY 2007 to 13 in FY 2008, a 58% decrease. 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.

### *Status of Prior Year OIG Comments*

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

#### *Improve Communications between the External Auditor and the Comptroller's Office*

Overall, our concern about communications has diminished substantially. As noted earlier, KPMG and OC continued to improve communications. OC meetings with KPMG and operating units continued to be productive. Nearly all operating units provided KPMG with better quality and more timely information.

Audit staff continuity, OC's regular meetings and correspondence with unit staff, status meetings, and the effective use of KPMG's PBC list to control the content and timing of data requests, all improved the quality and timeliness of the audit, resulting in, as described above, a two-week improvement in the issuance of KPMG's audit report.

#### *Perform More Robust Interim Testing*

Interim testing remains an area of concern. Last year, we observed that to enhance the efficiency and effectiveness of the annual financial statement audit, the Institution should place more emphasis on substantive interim testing of account balances and transactions. The Institution can thereby reduce the amount of year-end testing and also reduce the time needed to resolve audit differences and other issues. Further, moving some of the audit work to an earlier part of the year would reduce the impact of absences during the holiday season.

Although 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, the Institution did not make progress this year in conducting interim testing.

KPMG has suggested that an accounting close through May 31 would be a good place to start conducting audit work on interim balances. As it now stands, KPMG only performs limited substantive audit work at the interim period. Obtaining and testing more data in the form of a substantially complete trial balance, if only for a few accounts, could accelerate the completion of the annual audit.

We recommend that OC and KPMG develop and document a multi-year plan for interim testing that starts with what is currently feasible and grows into a comprehensive plan covering all significant and relevant account balances.

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

As with interim testing, the Institution has not made progress toward quarterly account closing and quarterly financial statements. Although we understand that it is a long-term goal, we continue to believe that the preparation of quarterly statements will add further discipline to the financial reporting process and will provide analytical data, detect problem transactions, identify changes in accounting procedures, identify breakdowns in controls, and serve as a monitoring tool for the Institution's activities.

We suggest that the OCFO continue its consideration of quarterly reporting.

*The Institution Needs a Comprehensive Plan*

Last year 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. 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.

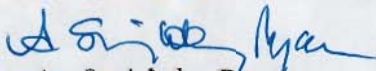
In January 2009, in response to recommendation 23 of the June 2007 Report of the Regents' Governance Committee, the OCFO presented to the Audit and Review Committee of the Board of Regents its draft *A Plan for the Strengthening Internal Controls* (the Plan) which addresses many of the elements noted 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."

Our office will monitor implementation of this plan, conducting audits as we deem appropriate.

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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     Chairman, 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 audits of the Institution's special-purpose federal financial statements, the Smithsonian-wide financial statements for FY 2008, SE's special-purpose statement of net gain, as well as the OMB A-133 audit for FY 2007.

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 2008 to March 2009 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.