



Smithsonian Institution
Office of the Inspector General

Date: January 27, 2020

To: Audit and Review Committee, Board of Regents
Lonnie G. Bunch III, Secretary

Cc: Mike McCarthy, Acting Chief Operating Officer and Under Secretary for Finance and Administration
Carol LeBlanc, President, Smithsonian Enterprises
Beth Cunigan, Controller, Smithsonian Enterprises
Martha Newton, Acting Director, Office of Finance and Accounting
Porter Wilkinson, Chief of Staff to the Board of Regents
Greg Bettwy, Chief of Staff, Office of the Secretary

From: Cathy L. Helm, Inspector General *CH*

Subject: Independent Accountant's Report on the Smithsonian Enterprises Net Gain for Fiscal Year 2019 (OIG-A-20-03)

This memorandum transmits the results of the Smithsonian Enterprise's Net Gain review for fiscal year 2019 performed by the independent public accounting firm of KPMG LLP (KPMG).¹ On January 24, 2020, KPMG issued its independent accountants' report on the Smithsonian Enterprises Statement of Net Gain, as of September 28, 2019. 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 2019 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

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 28, 2019

(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 Bunch
Smithsonian Institution:

We have reviewed the accompanying statement of net gain (as described in note 2) 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 28, 2019. 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

Washington, District of Columbia
January 24, 2020

SMITHSONIAN ENTERPRISES

Statement of Net Gain

For the year ended September 28, 2019

(Dollars in thousands)

Operating revenues, net:	
Merchandise sales	\$ 56,643
Media	38,569
Concessions, licensing, and other	<u>52,406</u>
Total operating revenues, net	<u>147,618</u>
Operating expenses:	
Cost of goods sold	26,424
Production costs	12,933
Circulation costs	11,150
Selling, general, and administrative costs	59,442
Depreciation and amortization	<u>4,880</u>
Total operating expenses	<u>114,829</u>
Net gain before gains on sales and increase in investment in Smithsonian Channel	32,789
Gains on sales	9,889
Increase in investment in Smithsonian Channel	<u>1,212</u>
Net gain - operating results	\$ <u><u>43,890</u></u>
Unrelated business income taxes	\$ (447)
Cumulative effect of accounting change	<u>(6,841)</u>
Net gain – after adjustment	\$ <u><u>36,602</u></u>

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

SMITHSONIAN ENTERPRISES

Notes to Statement of Net Gain

For the year ended September 28, 2019

(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 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 period presented in the statement of net gain and the supporting schedule of net gain by lines of business is from September 30, 2018 through September 28, 2019 (Fiscal Year 2019). 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 2019, there were no investments.

(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.

SMITHSONIAN ENTERPRISES

Notes to Statement of Net Gain

For the year ended September 28, 2019

(Dollars in thousands)

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 and contractors in advance of revenue recognition are deferred and included in the deferred revenues account.

During Fiscal Year 2019, Smithsonian sold the remaining interest in the Smithsonian Channel. Prior to the sale, SE recognized \$1,212 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 and direct response advertising expenses are recognized when related advertising materials are released. Such expenses amounted to \$8,667 for Fiscal Year 2019, 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 \$1,005 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 \$749 not billed to customers are included in selling, general and administrative costs.

SMITHSONIAN ENTERPRISES

Notes to Statement of Net Gain

For the year ended September 28, 2019

(Dollars in thousands)

(g) Income Taxes

The Smithsonian is a tax-exempt organization as described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code). Organizations described in that section are generally exempt from Federal income taxes, except for unrelated business income. SE's advertising sales are Smithsonian's principal source of unrelated business income.

The Tax Cuts and Jobs Act (the Act) was enacted in December 2017. Among other things, the Act imposes new taxes and establishes new rules for calculating unrelated business taxable income.

The statement of net gain includes an estimate for unrelated trade or business income tax based on the current proposed regulatory guidance. Smithsonian will continue to evaluate the impact of the Act on current and future tax positions.

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.

(h) Recent Accounting Pronouncements

In May 2014, FASB ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which, along with related amendments, replaces existing revenue recognition requirements. The core principle of Topic 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration it expects to be entitled in exchange. It also requires that costs associated with the preparation of long-lived materials, such as catalogs and campaigns to secure new subscribers be expensed at the date such materials are first issued. Previously, SE amortized such costs over the estimated useful life of such items.

SE implemented Topic 606 effective October 1, 2018, on a modified retrospective basis, which required the expensing of previously deferred costs of \$6,841. This adjustment is presented as a reduction of net gain in the statement of net gain.

(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 2019, SE's contribution expense under this plan amounted to \$3,227.

(4) Commitments and Contingencies

(a) Food Services Agreement

Under an agreement expiring in March 2026, a third party agreed to assist in the design, construction, and operation of food services at several Smithsonian museums and provided \$7,250 to fund capital improvements for the Food & Beverage Operations in the museums. The capital improvement projects selected are at the discretion of Smithsonian. The funding is recognized over the term of the agreement. Should the agreement be terminated, the agreement provides for the repayment of the

SMITHSONIAN ENTERPRISES

Notes to Statement of Net Gain

For the year ended September 28, 2019

(Dollars in thousands)

capital improvement costs based on the passage of time. Revenue recognized under the agreement in fiscal year 2019 was \$6,875 and is classified as commission revenue.

The third party also agreed to pay an annual fixed fee of \$100 over the term of the agreement. The annual fee is recognized as revenue upon receipt.

(b) Outsourcing Agreements

SE subcontracts infrastructure, transaction management services and systems support for its catalog business with fees based on services performed. Total fees paid for such services in Fiscal Year 2019 amounted to \$1,542 and are included in selling, general and administrative costs.

SE also subcontracts fulfillment services for its magazine circulation with fees based on the quantity of circulation. Such fees amounted to \$1,304 during Fiscal Year 2019 and are included in circulation costs.

During fiscal year 2019, 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 \$671 during Fiscal Year 2019. Such fees are included in selling, general and administrative costs.

(5) Gain on Sales of Equity Interest

In June 2019, Smithsonian sold its remaining interest in the Smithsonian Channel to its partner for \$25,500 and recognized a gain of \$9,851.

(6) Subsequent Events

Management has evaluated subsequent events from September 29, 2019 through January 24, 2020, 2020, which is the date that the statement of net gain is available to be issued, and determined that there are no adjustments to or other items to disclose.

SMITHSONIAN ENTERPRISES
Schedule of Net Gain by Lines of Business
Year ended September 28, 2019
(Dollars in thousands)

	<u>Museum services</u>	<u>Retail/direct</u>	<u>Media</u>	<u>Consumer and Education products</u>	<u>Corporate</u>	<u>Total</u>
Operating revenues, net:						
Merchandise sales	\$ —	53,696	2,947	—	—	56,643
Media	—	21	38,539	9	—	38,569
Concessions, licensing, and other	16,673	9,727	10,760	14,573	673	52,406
Total operating revenues, net	<u>16,673</u>	<u>63,444</u>	<u>52,246</u>	<u>14,582</u>	<u>673</u>	<u>147,618</u>
Operating expenses						
Cost of goods sold	—	22,589	2,156	1,679	—	26,424
Production costs	—	872	11,675	386	—	12,933
Circulation costs	—	100	10,368	682	—	11,150
Selling, general, and administrative costs	3,627	26,152	17,643	4,317	7,703	59,442
Depreciation and amortization	1,279	1,123	963	11	1,504	4,880
Total operating expenses	<u>4,906</u>	<u>50,836</u>	<u>42,805</u>	<u>7,075</u>	<u>9,207</u>	<u>114,829</u>
Net gain (loss) before increase in investment in Smithsonian Channel	11,767	12,608	9,441	7,507	(8,534)	32,789
Gains on sales	—	—	9,851	38	—	9,889
Increase in investment in Smithsonian Channel	—	—	1,212	—	—	1,212
Net gain (loss) – operating results	<u>11,767</u>	<u>12,608</u>	<u>20,504</u>	<u>7,545</u>	<u>(8,534)</u>	<u>43,890</u>
Unrelated business income taxes	—	(391)	(28)	(28)	—	(447)
Cumulative effect of accounting change	—	(1,234)	(5,607)	—	—	(6,841)
Net gain (loss) – after adjustment	<u>\$ 11,767</u>	<u>10,983</u>	<u>14,869</u>	<u>7,517</u>	<u>(8,534)</u>	<u>36,602</u>