Smithsonian Institution | Memo

Office of the Inspector General

Date January 27, 2017

To John W. McCarter, Jr., Chair, Board of Regents
The Honorable Barbara M. Barrett, 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, Acting Deputy Under Secretary for Finance and Administration and Chief Financial Officer
Chris Liedel, President, Smithsonian Enterprises
Bruce Dauer, Vice President, Finance and Administration, 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

From Cathy L. Helm, Inspector General Cathy L. Helm

Subject Independent Accountant's Report on the Smithsonian Enterprises Net Gain for Fiscal Year 2016 (OIG-A-17-03)

This memorandum transmits the results of the Smithsonian Enterprise's (SE) Net Gain review for fiscal year 2016 performed by the independent public accounting firm of KPMG LLP (KPMG).[1] On January 27, 2017, KPMG issued its independent accountants' report on the Smithsonian Enterprises Statement of Net Gain, as of September 24, 2016. 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 reports and documentation and interviewed its representatives. Our review of KPMG's fiscal year 2016 work disclosed no instances where KPMG did not comply, in all material respects, with the American Institute of Certified Public Accountants' 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 Smithsonian's Contracting Officer's Technical Representative for the oversight of KPMG's work.

SMITHSONIAN ENTERPRISES

Statement of Net Gain

For the period ended September 24, 2016

(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) and the supplemental schedule of net gain by lines of business of Smithsonian Enterprises, an unincorporated operating division of the Smithsonian Institution, for the period ended September 24, 2016. 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, DC
January 27, 2017

SMITHSONIAN ENTERPRISES

Statement of Net Gain

For the period ended September 24, 2016

(Dollars in thousands)

Operating revenues, net:		
Merchandise sales	$	56,522
Media		47,226
Concessions, licensing, and other		54,541
Total operating revenues, net		158,289
Operating expenses:		
Cost of goods sold		26,925
Production costs		17,140
Circulation costs		12,605
Selling, general, and administrative costs		61,032
Depreciation and amortization		3,397
Total operating expenses		121,099
Net gain before increase in investment in Smithsonian Channel		37,190
Increase in investment in Smithsonian Channel		2,434
Net gain		39,624
Add back: Net loss on new strategic business initiatives		2,115
Net gain excluding new strategic business initiatives		41,739
Non-operating adjustment related to income taxes		836
Net gain after adjustment	$	40,903

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

(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 27, 2015 through September 24, 2016 (Fiscal 2016).

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 2016, such investments increased net gain by $2,115.

(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.

(Dollars in thousands)

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 2016, SE recognized $2,434 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 $8,023, amounted to $12,867 for Fiscal 2016, 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 $1,438 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 $651 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

(Continued)

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 2016, SE's contribution expense under this plan amounted to $2,983.

(4) Commitments and Contingencies

(a) Food Services Agreement

SE, through Smithsonian, has an agreement, through March 2026, with a third-party to assist in the design, construction, and operation of food services at several Smithsonian museums. 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 $5,068 was recognized during Fiscal 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 $1,259 during Fiscal 2016. Such fees are included in selling, general and administrative costs.

Under a contract expiring in December 2019, a third-party to provide fulfillment services for its magazine circulation. Fees are based upon the quantity of circulation and amounted to $1,798 during Fiscal 2016. Such fees are included in circulation costs.

Under a contract expiring in October 2017, 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 $807 during Fiscal 2016. Such fees are included in selling, general and administrative costs.

SMITHSONIAN ENTERPRISES

Schedule of Net Gain by Lines of Business

Period ended September 24, 2016

(Dollars in thousands)

		Museum Services	Retail / Direct	Media	Consumer & Education Products	Corporate	New Strategic Business Initiatives	Total	Total excluding New Strategic Business Initatives
Operating revenues, net:									
Merchandise sales	$	—	54,582	1,891	—	—	49	56,522	56,473
Media		—	43	46,454	—	—	729	47,226	46,497
Concessions, licensing, and other		18,603	15,524	7,840	11,766	—	808	54,541	53,733
Total operating revenues, net		18,603	70,149	56,185	11,766	—	1,586	158,289	156,703
Operating expenses:									
Cost of goods sold		—	23,915	746	1,975	—	289	26,925	26,636
Production costs		—	2,986	13,034	240	—	880	17,140	16,260
Circulation costs		—	142	11,681	547	—	235	12,605	12,370
Selling, general, and administrative costs		1,786	25,529	19,315	3,596	8,576	2,230	61,032	58,802
Depreciation and amortization		1,221	1,081	376	12	640	67	3,397	3,330
Total operating expenses		3,007	53,653	45,152	6,370	9,216	3,701	121,099	117,398
Net gain (loss) before increase in investment in Smithsonian Channel		15,596	16,496	11,033	5,396	(9,216)	(2,115)	37,190	39,305
Increase in investment in Smithsonian Channel		—	—	2,434	—	—	—	2,434	2,434
Net gain (loss)		15,596	16,496	13,467	5,396	(9,216)	(2,115)	39,624	41,739
Non-operating adjustment related to income taxes		—	—	—	—	836	—	836	836
Net gain (loss) after adjustment	$	15,596	16,496	13,467	5,396	(10,052)	(2,115)	38,788	40,903