



Smithsonian Institution

CONFIDENTIAL

January 16, 2007

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

Dear Members of the Audit and Review Committee:

Attached please find the Independent Accountant's Report on Applying Agreed-Upon Procedures to a review of the Secretary's expenses, compensation, and donations for 2000 through 2005, which was conducted at the Secretary's and your request.¹

In this transmittal we offer comments and recommendations based on our oversight of the independent accountant's review, focusing on the Secretary's expenses. We note those transactions that we believe the Regents could find to be appropriate, even if the transactions did not strictly comply with Institution policies, as well as those that we believe the Regents could find inappropriate. In our view, the Institution would benefit from providing more specific guidance on expenses. In addition, we offer some observations on the Secretary's employment agreement and suggest that it be revised.

Our comments follow the order of the attached report.

The Secretary's Expenses

As a trust instrumentality of the United States and as a charitable organization under the Internal Revenue Code, the Smithsonian must ensure that expenses incurred by individuals in carrying out its mission are reasonable. The Smithsonian must also ensure that such expenses are properly documented; that they are for a Smithsonian purpose and not for personal benefit; and that they are not lavish or extravagant.

Overall, we saw no evidence of fraud or abuse associated with the expense transactions reviewed. We also saw no evidence that the expenses reviewed were solely for personal benefit. All the transactions for which there was support had a Smithsonian business purpose. However, many transactions were not properly documented or were not in accordance with Smithsonian policies. Additionally, some transactions might be considered lavish or extravagant.

¹ A separate report on a review of the expenses and compensation of the Chief Executive Officer of Smithsonian Business Ventures is forthcoming.

Unsupported or Inadequately Supported Expense Transactions (Schedule B-1)

Only 42 (or 4%) of the 1,040 transactions reviewed (totaling \$846,312.34) had inadequate support (documentation);² out of those 42, only 12 (or 1%, worth \$7,108.89) had no support at all. We note that where there is no support or inadequate support for the expense, there may be tax consequences to the Secretary.

- Accordingly, we recommend that the Board of Regents ask the General Counsel to review the tax implications, if any, of the Institution reimbursing unsupported and inadequately supported expenses.

Unauthorized Travel Transactions (Schedule B-1)

The report identifies nine travel transactions (related to four trips) as unauthorized. Six of these transactions involved a single, round-trip charter flight to San Antonio, Texas (totaling \$14,509.40), where the Secretary attended the opening of an affiliate museum and a function held by a potential major donor and then needed to return for a Board of Regents meeting.³ While the trip had a legitimate Smithsonian purpose and the charter flight ensured that the Secretary would arrive back in time for the Regents, the use of a charter flight was not authorized by his employment agreement or any Smithsonian policy and we therefore believe the cost was excessive. First-class roundtrip airfare – to which the Secretary is entitled under his employment agreement – between Washington, D.C. and San Antonio, Texas, at that time was approximately \$2,000.⁴

² The majority (34 out of 42) of these transactions date from fiscal years 2000 and 2001. It is not surprising that some percentage of records could not be located, given the time elapsed, the relocation of the Office of the Comptroller (including its voluminous and at that point poorly organized records) in 2000, and the turnover in personnel since then.

³ We note that a *Washington Post* account a few months after the trip cites an Institution spokesperson as saying that the Secretary paid for the trip from a discretionary fund with his own money. That characterization is inaccurate. The trip was paid for with Smithsonian funds. It is true that the Secretary has been very generous in his donations to the Institution (he gave almost \$430,000 in cash and securities in the period covered by the review), and these donations are allocated to a discretionary trust fund from which he may make expenditures on behalf of the Institution. However, once an individual has donated money to the Institution (and taken any resulting tax benefit), the donation becomes the property of the Institution and is subject to expenditure guidelines for "reasonableness" and other limitations flowing from the Institution's status as a trust and a 501(c)(3) organization. If the Secretary had paid for the charter flight with his own funds, the expenditure would not be subject to these restrictions, but it also could not be claimed as a charitable donation.

⁴ Two other transactions did not involve excessive expenditures. One involved a charter flight from Washington, D.C. to Pennsylvania (\$1,348.75) for a Smithsonian-related function, and that flight may not have cost much more than a commercial flight and attendant ground transportation to the area. The other was an overnight stay at a motel (\$67.06) near Dulles Airport when the Secretary was attending numerous functions related to the opening of the Udvar-Hazy Center.

- Accordingly, we recommend that the Board of Regents consider whether the Secretary's use of the charter flight was reasonable under the circumstances and if it was not, ask the Secretary to reimburse the Institution for the difference between first-class airfare and the cost of the charter flight, and ask the General Counsel to review the tax implications, if any, of reimbursing the cost of the charter flight.

The other travel transaction of concern is a reimbursement to the Secretary's wife for a trip she took to Cambodia with Smithsonian National Board members. Again, the trip clearly had a legitimate Smithsonian purpose, and we note that Smithsonian travel policy does allow the Institution to pay the travel costs of spouses of Smithsonian employees who are traveling to attend an official function "if their services in an official capacity can be demonstrated in advance." The independent accountant, however, was not provided with evidence of prior authorization or approval. We also note that the Institution's reimbursement of the Secretary's wife's travel expenses in this instance, and possibly in all instances, may have tax implications.

- Accordingly, we recommend that the Board of Regents ask the General Counsel to review the tax implications, if any, of reimbursing the Secretary's wife's travel expenses.

Unauthorized Non-Travel Transactions (Schedule B-2)

The independent accountant's report lists approximately 200 transactions (totaling \$67,865.40) as unauthorized non-travel costs, or 8% of the cost of all expense transactions reviewed. The majority of these transactions arguably were not inappropriate. Specifically, all but approximately \$5,700 of these non-travel transactions, while not allowed under then-existing Smithsonian policies, would be authorized under current policy or if a different category of Trust funds had been used. The expenditures were for Smithsonian purposes, and were not for personal benefit. Smithsonian policies at the time, however, were either ambiguous or did not necessarily recognize the purpose involved. According to the Secretary's staff, they believed that all these expenditures were allowed under Smithsonian policy or that the Secretary could waive any policy if it applied.⁵

There were 15 transactions (totaling \$2,679.73) involving the use of the Institution's "401 funds" (a type of Trust fund) for the purchase of alcoholic beverages for official Smithsonian functions prior to issuance of the new policy governing the expenditure of Trust funds in December 2004. Before that time, the policy was silent on the purchase of alcoholic beverages. The new policy allows the Secretary and other specified staff to purchase alcoholic beverages for official occasions using the Institution's "402 funds."

⁵ We are aware of no written authority for the Secretary to waive Smithsonian policies.

The independent accountant notes 104 transactions (totaling \$45,140.78) involving staff breakfasts and other meals with staff that the Secretary hosted through November 2004, which, according to the Secretary's staff, were working meals or staff morale-building occasions. In December 2004, Institution policy governing the expenditure of Trust funds was explicitly changed to authorize such expenditures by the Secretary.⁶ Thus, currently, these expenditures are allowed. We note, however, that there is no guidance that would help ensure that expenditures for these meals are kept within reasonable limits. In some instances, in our view, the cost of staff meals listed in the report might exceed what would be prudent under the circumstances. We also note that the policy on the expenditure of trust funds is an attachment to a trust fund allocation memo, rather than a Smithsonian Directive, the form Institution policies of long-term significance take.

The independent accountant also lists 66 gift transactions (totaling \$14,387.89) as unauthorized. As noted in the report, Institution policy does not permit the expenditure of Trust funds for gifts and therefore the expenses were unauthorized. While generally that rule is appropriate, we believe the Regents should consider authorizing the Secretary (and perhaps other Institution executives involved in development, such as directors of museums and other programs) to spend Trust money on gifts for donors and board members in gratitude for their generosity and service to the Institution, so long as those gifts are not lavish or extravagant. Such gifts strengthen relationships with donors, potential donors, board members, and volunteers. Some gifts to employees may also be appropriate, as they enhance employee morale. However, we also believe that there should be limits on gifts to employees and that those limits should be spelled out in appropriate guidance. For example, gifts could be restricted to the retirement of long-time employees or condolence flowers or memorial contributions on the death of an employee. In all instances, the Institution should be acknowledged as the source of the donation or gift. In addition, we note that, as with the expenditures on meals, some of the gifts listed in the report appear to be lavish.

- Accordingly, we recommend that the Board of Regents consider reviewing the transactions involving meals with staff and the purchase of alcoholic beverages for official functions to determine whether reimbursement would be warranted, recognizing that current Smithsonian policies would permit these expenditures.
- We also recommend that the Board of Regents direct the Institution to revise its policy governing the expenditure of Trust funds to allow the Secretary and other officials to use such funds for token gifts on behalf of the Institution to donors, board members, and volunteers, and for token gifts to employees on limited occasions; and to direct the Institution to develop a Smithsonian Directive, with Board of Regents approval, providing guidance on appropriate levels of expenditures for these purposes.

⁶ There were six occasions on which the Secretary had the Institution pay for personal lunches, but the Secretary reimbursed the Smithsonian for the full amount (\$700) on December 12, 2006, as well as for a spousal privilege fee (\$33.50) at the Cosmos Club that was reimbursed erroneously in 2000.

Finally, we note that there was a \$4,811.50 cash award in 2000 to an assistant to the Secretary that the independent accountant lists as unauthorized. Evidence provided to the independent accountant indicated that the purpose for the award did not meet Smithsonian standards for the granting of such awards, and no documentation was provided demonstrating otherwise.

The Secretary's Employment Agreement

The terms of the Secretary's employment agreement posed numerous challenges to the review of his expenses and, in particular, of his housing allowance. To avoid similar issues in the future and, more importantly, to clarify the agreement's terms, we suggest that the Board of Regents and the Secretary revisit the agreement, with the assistance of the Institution's General Counsel.

Travel Provisions

The Secretary's employment agreement explicitly authorizes the Secretary to fly first-class and states that Smithsonian travel policies – which follow the Federal Travel Regulation (FTR) – otherwise apply. Thus, on its face the agreement does not appear to allow the Secretary to exceed FTR limits on hotel charges and apparent limits on using car services. But the Secretary's travel costs did not always come within those limits.⁷ The representation letters to the independent accountant nonetheless established that the parties to the agreement (the Secretary and Board of Regents through its Executive Committee) believe that the agreement entitled him to premium travel in all regards, not just premium air fare. The independent accountant therefore did not ultimately categorize the expenditures for car service and premium hotel accommodations as unauthorized. While we do not suggest the Secretary be subject to the FTR (or limits other than his travel expenses should further the Institution's mission and not be lavish or extravagant),⁸ we believe there should be greater clarity and accountability.

- Accordingly, we recommend that the Board of Regents consider amending the Secretary's employment agreement to specify what level of travel service the Secretary is entitled to and what limitations, if any, should apply to his travel-related costs.

⁷ For example, the Secretary spent approximately \$27,000 on car service while on travel over the course of the 6-year review period.

⁸ We note that the Panel on the Nonprofit Sector's Summer 2005 Report to Congress and the Nonprofit Sector opposes limiting amounts paid by charitable organizations for travel, meals and accommodations to the federal government rate because doing so "would place an unreasonable barrier to many activities of [an] organization."

Housing Allowance Provisions

The Secretary's employment agreement also provides him with a housing allowance, as historically the Institution has provided its Secretary with a house and expects the Secretary to use it for official Smithsonian hospitality. As with the provisions having to do with travel, it appeared that the literal language of two provisions of the agreement was not followed: that the allowance is not to exceed a specified amount "in compensation for up to fifty percent (50%) of the actual costs of his housing;" and that payment will be made upon the Secretary's "presentation monthly of records of housing operating and maintenance expenditures including but not to be limited to: homeowner's insurance, utilities, ordinary maintenance and cleaning, grounds service, real estate taxes, mortgage interest or equivalent costs of home ownership, etc., but not capital expenditures."

We understand that for administrative ease, the Regents, a few months after the Secretary's arrival, ceased requiring monthly records of the Secretary's housing expenditures but did not amend the employment agreement accordingly. The Regents treated the allowance payments – which increased each year with his salary – as if they were lump-sum payments due in the same manner as his salary. As a result, when this review began, the monthly records of actual expenses had to be assembled for the independent accountant's review.

Further, the most significant housing expense listed is the Secretary's hypothetical mortgage interest, which is characterized as an equivalent cost of home ownership.⁹ The agreement does not explain how this imputed interest would be calculated. The independent accountant did not review the underlying assumptions or otherwise verify the resulting numbers. Yet those costs were the largest portion of the total housing allowance expenses. With different assumptions, it is possible the Secretary's costs would not have met the threshold necessary to receive the full amount of the housing allowance.¹⁰

- Accordingly, we recommend that the Board of Regents consider revising the Secretary's employment agreement to make the housing allowance a single yearly payment with no documentation of expenses or minimum amount required to qualify for the allowance; or, specify more clearly in the agreement what costs qualify for the allowance and what recordkeeping and reporting are required.

⁹ In their representation letters to the Independent Accountant, the parties to the agreement stated that they intended the Secretary's imputed mortgage interest to be an actual cost of housing that would count toward his housing allowance.

¹⁰ For example, had an adjustable rate mortgage been used to impute the mortgage interest, the overall costs could have been lower. The calculations prepared by the Office of the Secretary used a 30-year fixed rate mortgage rate of 8.32 percent from January, 2000. In 2000, the average 1-year ARM was 7.04 percent, and interest rates declined steadily to an average of 3.90 percent in 2004, then increased in 2005 to 4.49 percent. Alternatively, refinancing might have been an option; average 30-year fixed mortgage rates declined significantly from 2000 (when they averaged 8.05 percent) through 2005 (when they averaged 5.87 percent).

Recordkeeping Practices

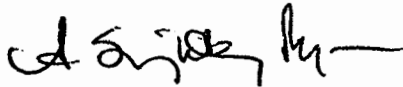
Finally, as a result of this review, it became apparent that the recordkeeping practices of the Secretary's office and the Office of the Comptroller need to be refined to allow for the separate tracking and categorizing of the Secretary's expenses. The records of the Secretary's expenses were not segregated from those of the Secretary's office as a whole (for such expenditures as office products; travel for the Regents; furniture and other items for the Castle; and the like). It was therefore initially difficult to determine which expenditures were attributable to the Secretary, find supporting documentation going back 7 years, and decide what types of expenditures were involved without having to look at the original receipts and other voluminous support.

Recognizing these problems, the Office of the Secretary, working with the Office of the Comptroller, the Office of the Chief Information Officer and our office, has already implemented a new coding system to track and categorize the Secretary's expenses more methodically beginning in fiscal year 2007.

Beginning this year, this office will conduct annual reviews of the Secretary's expenses. In an era of severe budget constraints and of congressional and public scrutiny of nonprofit executive compensation and expenses, reviews such as this one help assure that the Smithsonian is using its limited assets prudently and solely for the benefit of the Institution's mission. Examining the Secretary's expenses increases transparency and accountability and will thereby strengthen the trust and confidence of the public, Congress, and donors in the Institution.

We look forward to your responses to our recommendations. Please do not hesitate to call me on 202.633.7095 if you have any questions or would like any further information.

Very truly yours,



A. Sprightley Ryan
Acting Inspector General

cc Lawrence M. Small, Secretary
Sheila P. Burke, Deputy Secretary and Chief Operating Officer
John E. Huerta, General Counsel
Alice C. Maroni, Chief Financial Officer
Andrew J. Zino, Comptroller
James M. Hobbins, Executive Assistant to the Secretary