

**THE UNIVERSITY OF TENNESSEE BOARD OF TRUSTEES
AUDIT COMMITTEE
AUGUST 30, 2011, MEETING MINUTES**

Audit Committee members present: Chairman Mr. James Hall, Mr. Waymon Hickman, Mr. Doug Horne, Mr. D. Crawford Gallimore.

UT: Ms. Judith Burns, Mr. Bill Moles, Dr. Joe DiPietro, Mr. Keith Carver, Mr. Charles Peccolo, Mr. Ron Maples, Mr. Chris Cimino, Ms. Joan Cronan, Mr. Bill Myers, Mr. Scott Studham, Ms. Gail White, Mr. Bob Hunter, Audit and Consulting Services and other UT staff.

Mr. James Hall welcomed members of the Audit and Consulting Services staff to the meeting and stated his and the committee's appreciation of the work they did and the importance of their service to the university. He then called the meeting to order. Mr. Hall discussed the minutes from the last meeting. There were no additions or corrections. A motion was made by Mr. Waymon Hickman to accept the minutes; the motion was seconded by Mr. D. Crawford Gallimore, and the minutes were approved unanimously.

Information Security Strategy – Mr. Scott Studham, the university's chief information officer, presented an overview of a new strategy for information security at the university. Mr. Studham showed a list of higher education institutions with data breaches over the past couple of years that resulted in lost records of personally identifiable information. He explained that universities can incur a loss of credibility or even fines ranging from \$50,000 to \$1.5 million, depending on the type of data lost. He noted UT has not had such a data loss since 2006, indicating we are managing information security adequately.

Mr. D. Crawford Gallimore asked what constituted personally identifiable information. Mr. Studham responded that state statute defines such information as the combination of a first and last name plus some other personally identifiable record, such as a Social Security number, credit card number, or driver's license number.

President Joe DiPietro asked what was meant by "loss." Mr. Studham stated a loss was a situation where an adversary removed information from an institution's network with the intent to use it. So "loss" means loss of control of the information.

Mr. Studham said he wanted to highlight that information security is about managing risks and that the university will never be able to completely eliminate the risk of security incidents. He explained the various types of "hackers," their motivations, and the approach the university must take to each to remain secure. A lot of time, he said, is spent with "script kiddies," computer science students motivated by curiosity to simply see what they can do. "Hobbyist hackers" are those who are motivated to seek personal fame by bragging about breaking into the university's systems to, for example, create a denial-of-service attack, which floods a network with information so that it cannot be used. Of greater concern is the "expert hacker," who is motivated by personal or corporate gain. These individuals could, for example, send an e-mail to download a virus to a computer so that it can be used to send spam. Returning students sometimes bring viruses when they return from home, where they have no protection. The UT security staff are constantly remediating the network. The "specialist hacker" is one motivated by national interest, and the university would not be able to stop this level of hacker.

Mr. Studham noted in the past the university defined its own security standards and wrote its own information security policies, but each time a new policy was written our adversaries found a way around it. Therefore, the new strategy is to use standards from the National Institute of Standards and Technology

(NIST). UT has issued a policy requiring each campus to have a security plan based on NIST standards. The focus can now be on security instead of writing policies. Also, most federal grants require us to follow NIST. The NIST process is to categorize an information system by considering three factors: confidentiality, integrity, and availability. Security controls are then selected, implemented, and monitored. The campuses will be responsible for categorizing the system and selecting and implementing the controls. A separate group at the system level will conduct independent verifications to determine whether the national standards were followed, a commensurate control was used in place of a standard that could not be implemented, or the risk was assumed by senior management. Monitoring is a dual responsibility between the campus conducting real-time monitoring as outlined in the security controls and the system responding to incidents and conducting penetration testing, an assessment to determine whether a campus notices an attempt to break into its systems and how the campus responds and follows the appropriate incident reporting process.

President DiPietro asked how often penetration tests were conducted and what was the industry standard. Mr. Studham explained these tests were begun this year and each campus should be tested once a year. He added that the Chattanooga campus has met or exceeded every security test.

Mr. Studham commented that the campus security plans are aligned with the campus's mission and are, therefore, drastically different. The campuses create their own plans, and the system security staff provide consulting and guidance to ensure consistency across the university. A year and a half into the transition to the new security strategy shows improved security through consistency and a common statewide framework. Also, consistent audits and assessments can be provided and, because national standards are used, independent consultants can be used.

Mr. Gallimore asked to whom the campus-level security staff report and to whom Mr. Studham reports. Mr. Studham explained that each campus has its own information technology organization that reports to the chancellor and that he reports to Dr. David Millhorn at the system level.

Higher Education Funding Formula – Dr. Russ Deaton, associate executive director of fiscal policy and administration from the Tennessee Higher Education Commission (THEC), joined the committee by telephone to discuss the new higher education funding formula. Ms. Judith Burns, interim executive director of Audit and Consulting Services (ACS), first explained how the funding formula affected the work of ACS. She explained that the Complete College Tennessee Act of 2010 (CCTA) required a significant restructuring of the funding formula, changing it from an enrollment-driven formula to an outcomes-based formula involving several factors such as research funding, graduation rates, and degree production. She stated that for many years, at the request of the Division of State Audit, UT's internal audit department conducted "enrollment audits" to verify the accuracy of the enrollment data sent to THEC. State Audit has asked ACS to continue auditing the data submitted to THEC, but the change to a more complex formula with multiple factors will involve significant effort. ACS will have to understand the new formula at a detailed level, and a risk assessment must be performed to identify the focus areas for the new audit.

Dr. Deaton thanked the committee for the opportunity to speak and introduced Mr. Chris Brewer, director of student information systems for THEC. Dr. Deaton began by providing the background and overview of the new formula. He explained that CCTA's most significant reform was by addressing the question of how state government should determine funding for higher education. Rather than continuing to fund on a cost reimbursement basis according to student enrollment as was the practice in Tennessee and other states for decades, the new formula uses two new features to determine funding. The first is the use of outcomes, paying institutions for what they produce or for their productivity. The second assigns a weight for each outcome according to an institution's mission.

Dr. Deaton described the outcomes that are measured each year, including the number of degrees (bachelor, master, law, etc.), students who achieve certain benchmarks (24, 48, 72 hours), and graduation rates.

Mr. Hall asked whether the benchmark hours pertained to hours earned in any coursework or only to the student's major. Dr. Deaton responded that any credit hours were counted and that the hours could be earned at any institution. The institution where the student is enrolled when the benchmark is achieved gets the credit.

Dr. Deaton expanded on the weighting of various outcomes, noting the weights reflect the mission of the institution. For example, as research or graduate degrees become more important to a campus, they are weighted more heavily in the formula. He noted such weighting is unique in higher education funding policy. Dr. Deaton stated the model includes a 40 percent premium for low-income and adult students so that, if 100 low-income students earn bachelor degrees, the institution is given credit for 140.

Mr. Hall asked for the definitions of low-income and adult. Dr. Deaton explained that, if a student is eligible for the federal Pell Grant program (family income of \$30,000-40,000), he or she is considered low income, and an adult is anyone age 25 and above, a nationally recognized benchmark. He noted a student would not have to have actually received a Pell Grant to be considered low income.

Dr. Deaton identified the advantages of the new model as including student successes and outcomes that have never before been factors, emphasizing institutional missions, accommodating any future shifts in mission or desired outcomes, and being simpler and more transparent for state government.

Mr. Hall asked how research is measured, and Dr. Deaton explained it is measured by annual research expenditures, a number the institutions provide to THEC.

Mr. Bill Miller of the audit staff asked how out-of-state students are handled in the formula. Dr. Deaton explained that, if students paid out-of-state tuition, some revenue is deducted from the model since the tuition revenue replaces some of the state subsidy. He noted the out-of-state students' outcomes would be counted; only the revenues would be handled differently.

Dr. Deaton stated Tennessee is leading the nation in making its funding formula more efficient and focusing on outcomes rather than enrollment. He stated THEC had received calls from at least 25 states and 3 foreign countries about in the new funding policies.

Dr. Deaton made some observations the audit staff should consider when conducting the risk assessment on the new formula. He noted the data used in the model is primarily from THEC's student information system managed by Mr. Brewer, which includes data that has been collected for decades. Therefore, there is nothing new in the data collection process. The shift is in which data is reviewed. No longer is enrollment at the beginning of the semester a factor; now end-of-semester course completions is the focus.

Some information is now critical to the formula, including student birth date, which is needed to determine whether the student is an adult and, therefore, counted with a 40 percent premium in the formula. Previously earned credit hours for transfer students must be accurate or institutions could be shortchanged in the formula. Accurate data on first-time, full-time freshmen is needed to calculate the graduation rate accurately. Dr. Deaton emphasized it is critically important that institutions provide timely student data updates to THEC. In summary, Dr. Deaton said now all data submitted to THEC is important because it is connected to dollars.

Mr. Waymon Hickman asked whether THEC would be the gatekeeper, determining whether institutions are compensated fairly for the work they are doing. Dr. Deaton replied that THEC, using the formula, would determine what portion of the funding appropriated by the legislature each institution would receive.

Mr. Doug Horne asked Dr. Deaton to provide his personal opinion of the new formula, who replied that he was 100 percent committed to this approach, noting that schools seem now to be more energized about being more productive, so it seems state government has identified the correct incentives.

President DiPietro stated he believed in the formula and thought UT will perform well but observed that, while the formula provides a great approach, the university is chronically underfunded regarding the percentage of the formula the state actually allocates. Funding is currently about 60-65 percent of what the formula indicates.

Mr. Hall asked Mr. Brewer to identify his biggest challenge and wondered whether he would need more staff or if most of the work has to be done at the campuses. Mr. Brewer responded that most of the work is done by the campuses and there was not much change for his staff since THEC has collected the data for some time. He said he has spent time working with institutions to resolve discrepancies between their data and THEC's, which usually resulted from the institutions not providing updates to THEC in the past.

Mr. Gallimore asked whether UT received funds as specific benchmarks were crossed or only when a student graduated. Dr. Deaton explained that as various outcomes are triggered, such as a student reaching 24 credit hours, they are counted and accumulate so that they can be counted in the formula. He further noted that schools are competing with each other so that, even if a school improves, it may fall behind if other schools are improving at a faster rate.

President DiPietro commented that if institutions improved by 1 percent, \$3.5 million additional dollars would be required. Otherwise, the funds would have to be shifted internally.

Ms. Leigh Cheek of the audit staff asked how incomplete grades are handled. Dr. Deaton explained that incompletes would not be counted since credit hours would not accumulate. Mr. Miller asked whether the new formula would be appropriations neutral, and Dr. Deaton said the formula would not shift the percentage of funding received. He stated in the 2011-2012 budget year the formula was funded about 58 cents on the dollar, so there was no shift.

Mr. Hall asked what is being done at the system level to ensure that institutions do not try to artificially increase results to get funding. Ms. Burns replied that the concern about the integrity of the data is the reason for State Audit's request for the University of Tennessee and the Board of Regents institutions to continue conducting audits to ensure that oversight exists to detect or deter the urge to inflate unnecessarily.

Update on Institutional Compliance – Mr. Bill Moles, director of Institutional Compliance, provided an update on the activities of the UT Institutional Compliance division. He began with a progress report on the UT Knoxville (UTK) compliance risk assessment. He stated that, as the UTK Compliance Committee has reviewed compliance issues, the number of risks being addressed has grown from 104 to 148. Of those 148 risks, 52 are in the safety/environmental area and 72 in the research area. The Institutional Compliance office reviewed preliminary plans of corrective action for these risks and recommended controls to the compliance officers they needed to include or consider. His office then gave the compliance officers instructions for developing detailed plans of corrective action. The plans will include specifics on all actions to be implemented and required resources. To date, over half of the plans have

been completed, and the rest should be completed by the end of September. Mr. Moles explained that, once the compliance officers complete their plans, the UTK Compliance Committee will review them for appropriateness and establish a priority list. This report will then go to the chancellor for his approval.

Mr. Moles also noted that the process for a risk assessment at the UT Health Science Center has begun. He stated he has initially identified the compliance officers and is working with Dr. Ken Brown, executive vice chancellor and chief operations officer, who will be involved in launching the risk assessment. Mr. Moles explained that the Institute of Agriculture is still identifying its compliance officers. Finally, he stated applications are being accepted for an institutional compliance officer position to be located in Knoxville. He said several good candidates have been identified.

President DiPietro stated he felt comfortable with the progress in institutional compliance so far and asked Mr. Moles what he thought was the university's most significant vulnerability. Mr. Moles replied that a number of compliance issues have been identified and many are in the safety area, which will require funding to address, but specific priorities are still being identified.

Performance Auditing – Ms. Burns provided an overview of a new initiative for Audit and Consulting Services—performance auditing. Ms. Burns began by explaining that this initiative was begun at the request of Chairman Hall and that last fall Mr. Charles Peccolo, UT interim chief financial officer, had agreed to fund two positions over the next two fiscal years toward this initiative. One position is in the process of being advertised, and Ms. Burns noted she would like to obtain any comments or feedback from the committee on this initiative before proceeding to fill the position.

Ms. Burns explained that she investigated the U.S. Government Accountability Office's (GAO) performance auditing program since this agency performed the audits Mr. Hall was familiar with when he chaired the National Transportation Safety Board. She said she found the GAO's program to be similar to the management consulting function she managed and was formerly part of ACS.

Performance audits, Ms. Burns explained, focus on efficiency and effectiveness, and the goal is to recommend operational improvements, facilitate executive decision-making, and improve management accountability. She stated such audits could be performed of a process or function (such as procurement or information technology); a program, project, or activity (such as the establishment of a biofuels initiative); or an entity (such as the payroll office or transportation services department). Performance audits address questions such as whether efficient operating procedures have been used, objectives are being met, and adequate management systems exist to measure, report, and monitor efficiency and effectiveness.

Ms. Burns stated projects would be requested by members of the president's staff, campus and institute chief business officers, or members of the Audit and the Effectiveness and Efficiency for the Future committees of the Board. Projects that affected the entire UT system would be given priority, along with those with known inefficiencies or ineffectiveness, where cost savings or improvements are expected, and areas of high visibility or financial significance.

Ms. Burns explained that she was proposing that the performance auditing function become a separate division of the office, like the institutional compliance function, for three reasons: 1) performance audits have different objectives than financial or compliance audits, 2) the skill set and necessary experience for staff conducting these projects are distinct from the other areas of the office, and 3) a separation of those staff who recommend operational/management changes from those who audit is needed to maintain independence and objectivity.

Ms. Burns stated the performance audits would result in reports written to the management of the area involved, the individual who requested the review, UT senior management, and the audit committee. The management of the area involved would be expected to carefully consider the recommendations and explain why recommendations were or were not implemented so as to improve how these reviews are conducted.

Ms. Burns concluded by stating that the benefits of performance audits, in addition to improved efficiency and effectiveness, include providing a forum for best practices within the university and becoming a tangible demonstration to the university's stakeholders of our responsible stewardship of the funds entrusted to us.

Mr. Horne stated he felt this function would work well with the Effectiveness and Efficiency Committee and encouraged that staff assigned to these projects have a business background with knowledge of management issues, not just accounting. He asked whether ACS currently had anyone in this area, and Ms. Burns responded that the office currently had only one staff member who is relatively new to this type of work and the plan with the newly created position is to recruit someone with experience. Ms. Burns noted in the past, in the management consulting function, the office tried to hire individuals with managerial experience who could make recommendations about organizational structure, staffing assignments, and workflow. She noted that, like the Effective and Efficiency Committee, the performance auditing function would examine those issues and not only address cost cutting. Sometimes to improve effectiveness, resources must be added.

Mr. Horne said he would like to see more reviews done with in-house staff rather than outside consultants. Costs could be saved since overhead and travel expenses would not have to be paid to internal staff. Ms. Burns agreed and noted that these types of reviews are very time consuming, with a short one lasting perhaps six months, which meant that with the function just starting out with one experienced staff, the result would be one or two projects per year. She stated that, as the office built expertise in this area and had some results to show, the function could be enhanced.

Mr. Horne noted that, with these types of reviews, staff should be cautious since they may be reviewing areas where management has been in place a long time and must, therefore, approach them with the attitude of trying to assist rather than identifying areas where they are not doing something right.

Mr. Gallimore cautioned that staff performing such reviews can become invested in the outcome and, if the recommendations are not implemented, friction could result between the auditor and management. He stated the auditor's job is to identify best practices and not be concerned with whether the recommendations are implemented. The staff must bring their suggestions to management who has responsibility for implementing changes. He stated staff who perform this type of work often misinterpret their role.

UT Knoxville Athletics Department Support – Ms. Joan Cronan, interim vice chancellor and director of Athletics, and Mr. Bill Myers, senior associate athletics director, presented an overview of the support the UTK Athletics department receives from the university and provides to the campus. Ms. Burns explained that she had received questions about a June *USA Today* article listing certain athletics departments, including UTK's, that were not self-supporting. The article claimed UTK Athletics received an annual subsidy of \$12-13 million. Ms. Burns stated the committee knew from previous presentations by Mr. Myers that this information was inaccurate, so she asked Ms. Cronan and Mr. Myers to clarify the information for the committee.

Ms. Burns stated Internal Audit would review this issue of support provided by the university to Athletics and vice versa and would issue a report when the review is complete.

Mr. Myers began by reminding the committee that the National Collegiate Athletic Association (NCAA) requires Athletics to submit a financial statement each year. The state's Division of State Audit works with Athletics to ensure that NCAA regulations regarding the reporting of revenues and expenses are followed. Mr. Myers stated around 2005 the NCAA became concerned about the growing expenses in intercollegiate athletics and the toll those expenses were taking on universities' budgets. As a result, the NCAA began requiring institutions to report "indirect administrative and facilities support." Mr. Myers stated that, of the 65-70 schools in the Bowl Championship Series (BCS) category, only 15 reported a number for indirect support. Of the 12 institutions in the Southeastern Conference (SEC), UT was the only one to report indirect support. Because the number UT reported was more than double that reported by the 15 BCS schools, it attracted attention in the newspaper.

Mr. Myers provided a document showing the total indirect support reported on the financial statements submitted to the NCAA for fiscal year 2010 was \$12.6 million and the total direct support \$1 million. The direct support is from student activities fees. The indirect support is comprised of the following: \$1.7 million from services provided by various offices on the Knoxville campus (such as the Vice Chancellor for Finance and Administration, Human Resources, and Office of Information Technology Customer Technical Support); \$1.5 million from services provided by the UT system administration (such as Audit and Consulting Services, General Counsel, and Purchasing); \$1 million of indirect facilities support (services from areas such as Real Estate Management, Facilities Planning, and Care of Grounds); and \$8.4 million from depreciation expenses for athletic facilities.

Mr. Myers also showed the committee a report of cash support the Athletics department provided to the university in fiscal year 2010. The \$7 million included funding for chancellors' discretionary funds (\$2.8 million), academic scholarships (\$1.4 million), parking garage debt service (\$1.1 million), and graduate assistant support (\$800,000). Subtracting the \$1 million in student activities fees, the net cash support from Athletics to the university is approximately \$6 million. Mr. Myers noted that the department previously received \$2.5 million from student activities fees. Ms. Cronan said that was the amount when she was hired in 1983 and her charge was to reduce that amount by raising money and selling tickets. The amount was reduced to \$1 million many years ago, she said, and the department would like to eliminate that amount.

Mr. Myers noted that the NCAA financial report does not include cash provided to the university because the majority of schools only receive money from their campuses. He stated he and a counterpart from another university met with the NCAA director of finance to request that this information be included in the report and it might be required for fiscal year 2011. He said the NCAA would examine the issue of reporting the indirect administrative and facilities support, though there would not be time to change it for 2011.

Mr. Horne asked which SEC athletics programs other than Tennessee's provided money to their universities. Mr. Myers responded that Louisiana State University (LSU), the University of Georgia, and the University of Florida did, while Auburn and Alabama receive more money than they provide. He stated LSU provided about \$6-7 million, roughly the same as UT. He noted that last year Georgia provided the campus with around \$3 million, while Florida provided about \$6 million from a television contract. He said UT and LSU are the only schools providing money on a recurring basis.

Mr. Horne asked whether the department's contributions had decreased, and Mr. Myers replied that Athletics was at the same point as last year at this time and total giving was more last year than the

previous year. Mr. Horne also asked how much of the department's debt was short term. Mr. Myers stated that, of the current \$196 million of debt, approximately \$45 million of it is under five years. Mr. Horne also mentioned that the Athletics department should have an effectiveness and efficiency program and Ms. Cronan agreed.

Mr. Hall asked Mr. Peccolo to explain why depreciation was included in the financial report. Mr. Peccolo replied that the NCAA required it. Mr. Bob Hunter, manager from the Division of State Audit, whose staff prepare the report, confirmed this and stated his office had called their NCAA representative, who confirmed the depreciation should be reported.

Ms. Cronan stated the department would continue to work to change the reporting so that all schools are reporting equally.

Mr. Horne asked how the *USA Today* staff obtained the information contained in the article. Mr. Myers explained that the financial reports are completed online and the database was made available by the NCAA.

President's and Chancellors' Discretionary Expenditures – No exceptions were noted.

Exceptions in Travel Expenditures – One minor exception was noted. Expenses were incurred by Dr. Steve Schwab for a cancellation of a professional development conference.

Housing Exception Report – One minor exception was noted. A budget adjustment was needed for the removal of some fallen oak trees at the former president's residence.

Audit Staff – Ms. Burns introduced each member of the Audit and Consulting Services staff, indicating their responsibilities and asking them to tell the committee how long they had been with the audit department and at UT.

Mr. Hall stated the audit committee's appreciation of the staff's work and told them the members of the committee spend a considerable amount of time reviewing their work. He stated audit was an important function for the university and he appreciated President DiPietro and Mr. Peccolo for addressing the committee's concern about adequate staffing in this area.

Executive Director Search – Mr. Peccolo gave the committee a brief update on the search for the executive director of Audit and Consulting Services.

Respectfully Submitted,



Judith A. Burns
Interim Executive Director, Internal Audit
The University of Tennessee