

**THE UNIVERSITY OF TENNESSEE BOARD OF TRUSTEES
AUDIT COMMITTEE
DECEMBER 10, 2010, MEETING MINUTES**

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

UT: Ms. Judy Burns, Mr. John Fox, Mr. Bill Moles, Ms. Leigh Cheek, Mr. Mark Paganelli, Mr. Charles Peccolo, Mr. Ron Maples, Dr. Jan Simek, Mr. Hank Dye, Mr. Anthony Haynes

Mr. James Hall 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.

Results of Quality Assurance Review – Ms. Judy Burns led the discussion of the results of the quality assurance review of the internal audit function conducted in October. She noted the official letter to the committee presented in the meeting materials indicated the review team concluded that UT’s audit function “generally conforms” to the standards of the Institute for Internal Auditors (IIA) and its code of ethics. This rating is the highest possible rating that can be conferred as a result of such a review. The leader of the review team, Ms. Sandy Jansen, assistant chief audit executive of the Texas Tech University System, joined the meeting via telephone to present an overview of the team’s findings and three recommendations for future action by the Audit Committee.

Ms. Jansen first identified the rest of the review team as Ms. Sabrina Hearn, general auditor of the University of Alabama System; Ms. Toni Messer, executive director of Audit and Compliance at the University of Texas at Dallas; and Ms. Deanna Metts, director of Internal Audit at Tennessee Tech University. She noted the team found a number of best practices in place at UT, including a comprehensive audit manual; automated workpaper system, which helps the office be more efficient; a mentoring program for new employees; continuing professional education for all staff; and a career ladder with details on the responsibilities and skills needed for each job. In addition, Ms. Jansen noted items that she and the team found particularly useful for their own organizations: the *UT Business Management Guide*, used to educate department heads on their fiscal responsibilities, and the *Fringe Benefits Guidebook*, developed for the UT president and his executive staff to educate them on the policies and procedures governing the use of their benefits and other important items.

Ms. Jansen also described the three recommendations requiring the Audit Committee’s action. First, the team agreed with Audit and Consulting Services’ self-evaluation, which recommended the review and approval of the internal audit and audit committee charters annually. She also recommended that the interim executive director review the internal audit charter after the release of updated IIA standards, to be issued in 2011. Second, she noted the team determined that Internal Audit is independent as required by the standards and the functional reporting line to the Audit Committee provided for that independence. The team recommended that the Audit Committee review the executive director’s administrative reporting relationship to the chief financial officer (CFO) annually to ensure that independence is fostered and adequate resources are provided to the department. She reported the team felt strongly that the reporting relationship to the current CFO provides independence, but given the importance of independence in audit work, the relationship should be reviewed regularly. Finally, Ms. Jansen reported that in reviewing the standard that requires the chief audit executive to ensure resources are appropriate, sufficient, and effectively deployed to achieve the approved plan, the team examined the salaries of internal audit professional staff. She stated their review indicated salaries appear to be low, especially for positions with leadership responsibilities and specialized skills, such as information technology. She noted that the university’s diverse and complex environment requires that salary levels remain competitive to recruit and retain the high-quality professional staff that is needed. The team recommended

that the Audit Committee and executive management evaluate internal audit staff salaries on a periodic basis to ensure they remain competitive. Ms. Jansen summed up her overview by reporting that Ms. Burns agreed to help the committee implement these three recommendations. She also noted the team provided Ms. Burns with some internal operational enhancements for the department. Ms. Jansen concluded by saying the review team members were able to take away from the experience at UT ideas for improving the audit functions at their own campuses.

Mr. Hall asked Ms. Jansen to comment on how UT Internal Audit's functional and administrative reporting relationships differed from other organizations or recommended practices. Ms. Jansen responded that in many cases internal audit reports functionally to the audit committee as at UT but administratively to the chief executive officer (CEO). She stated IIA's "practice advisories" discuss audit departments reporting to the CEO, but these advisories are not mandatory, simply issued to provide guidance, so UT's structure is still in line with IIA standards. She continued that she understood historically UT's structure has worked well, but the team felt the committee should review the relationship periodically to ensure it still functions as well as it does today.

Mr. Mark Paganelli offered some background on the evolution of Internal Audit's administrative reporting relationship, stating the office formerly reported administratively to the president, but questions were raised about the effectiveness of this arrangement after issues arose about the appropriateness of a past president's actions. Then the Audit Committee was formed and the reporting was changed to the CFO. Mr. Paganelli noted that, as audit director, he preferred reporting to the CFO, a position that is familiar with audit work and often has more time available than a president. He noted the audit director is part of the president's staff and is therefore engaged with the president.

Mr. Hickman asked Ms. Jansen what the team had learned about the level of support for Internal Audit expressed by the chancellors and the president. She responded that all members of management with whom the team spoke were very supportive of the way the audit function conducted its work, the results of the work, and the assistance audit provided them. She concluded all seemed to have respect and appreciation for the audit function.

Mr. Gallimore asked Ms. Jansen what benchmark was used for the comparison of staff salaries. She replied the team used information on schools of comparative size from the state of Texas and the University of Alabama. She stated they looked closely at the salaries for information technology (IT) auditors because those staff are difficult to recruit and retain and require high salaries.

Mr. Hall asked if the team reviewed IT staffing at UT since only one individual was assigned to such audits. Ms. Jansen reported the team reviewed that issue and concluded that, if UT were to increase resources, IT auditing would be the place to increase because IT is integrated throughout a university.

Mr. Murphy thanked Ms. Jansen for her thoughts on how to continue reevaluating the audit structure and salaries. Dr. Jan Simek noted that sufficient compensation is a problem throughout the university, adding that Internal Audit was probably too lean and additional resources could be used. Mr. Charles Peccolo commented that he and Ms. Burns have discussed a plan to increase staffing in certain areas.

Ms. Burns then presented plans for enhancing internal operations in three areas. These ideas were prompted by the quality assurance review. First, to enhance the continuing quality assurance efforts already in place, she noted three actions that would be taken: 1) an end-of-project checklist will be created to ensure auditors' work conforms to IIA standards and office policies and procedures, 2) a workpaper review project will be assigned with the objective of ensuring both audit staff and reviewers conform to the standards (the project will also serve as a training mechanism to expose staff to multiple ways of conducting and documenting work), and 3) the office's performance metrics will be reviewed to ensure appropriateness.

Second, Ms. Burns explained that several enhancements will be made to the audit planning process. The office's risk assessment process will be documented in the audit manual so that all staff, not just management, understand how the annual audit plan is developed. To show how the risk assessment is tied to the plan, both the source and objectives of the project will be documented in the plan. Third, several actions regarding staffing will be taken, including assessing the IT audit coverage provided by the office, developing a plan for benchmarking salaries, and documenting the office's long-range staffing plans.

Demonstration of Risk Assessment Tool – Ms. Leigh Cheek and Mr. Bill Moles demonstrated and discussed the online risk assessment tool they developed for the institutional compliance function. The presentation showed how the tool streamlines the process and the type of information collected. The tool was first used by the 72 compliance officers on the UT Knoxville campus. Ms. Cheek logged onto the website and demonstrated the steps a compliance officer would take to complete the assessment. The officer would select his/her name from a list, which would automatically provide a list of all the regulations for which the officer is responsible. For each regulation, the officer would enter any potential violations that could occur and would then be prompted to rank the impact of the violation if it were to occur on several dimensions, including financial, legal, operational, and reputational. The estimated frequency with which the violation would likely occur is then specified. The tool next prompts the officer to describe the extent to which key controls are implemented, specifically the controls of policies and procedures, training, and monitoring. Finally, the officer is asked to indicate whether any external reviews of the regulation have been conducted or any findings or penalties received and whether the officer believes the campus/institute is out of compliance or a significant number of control weaknesses exist. Mr. Moles pointed out that the tool significantly streamlines the risk assessment process for both the compliance officers completing the assessment and his office in collecting the data, tracking the compliance officers' completion of the assessment, and analyzing the data.

Mr. Gallimore asked whether the violations identified had previously occurred or were those that could potentially occur. Mr. Moles explained that the assessment asked for both. First, the officers are asked to identify the most significant violation they could face, and are asked later to identify any instances where they believe the university is out of compliance or where violations have actually occurred. Mr. Gallimore asked if the violations were of state and federal laws as opposed to violations that risk the health and welfare of students and staff. Mr. Moles said the assessment identified both violations of laws and regulations, including those that address health and safety issues.

Mr. Hall asked how priorities would be determined, and Mr. Moles explained it is the responsibility of each campus compliance committee. Mr. Murphy noted the purpose of this risk assessment was not to correct violations, but to develop a process by which the most significant risks could be identified so that resources could be provided to monitor and address them. Mr. Murphy then asked whether Mr. Moles felt confident that the universe of regulations was complete, and Mr. Moles stated he was constantly reviewing the universe, having begun with only 160 regulations and expanding to approximately 400. Mr. Hickman noted if the university continued to do all that was required in the compliance area, more resources would likely be needed.

Institutional Compliance – Mr. Moles gave an update on the institutional compliance program, identifying the key activities outlined in the Institutional Compliance Operating Plan for 2011. The primary focus at the beginning of the year will be providing direction to the newly formed UTK Campus Compliance Committee, including 1) create the methodology for assessing the preliminary results of the risk assessment, collecting additional information, and determining priorities; 2) facilitate the process for determining priorities, developing plans of corrective actions, and following up; and 3) assist the committee in its reporting responsibilities to the chancellor, the Executive Compliance Committee, and the Audit Committee. Other key activities include: begin the risk assessment process at the Institute of Agriculture and UT Health Science Center, promote the newly revised UT Code of Conduct (including

introducing the Code to new employees in orientation, conducting an awareness program for current employees, and launching a website that directs employees to relevant policies, procedures, and training), develop and promote a compliance hotline, resume the Executive Compliance Committee meetings, and hire an institutional compliance officer at the beginning of the new fiscal year.

Mr. Hall asked where the new institutional compliance officer would be located, and Mr. Moles replied the first hire would be located in Knoxville for ease of training and the next hire would be located in Memphis.

2011 Audit Plan – Ms. Burns presented the proposed 2011 audit plan for the committee’s approval. She presented the plan in three views to show how the projects were selected, the types of projects to be conducted, and how the effort is distributed to the various campuses and institutes. Ms. Burns stated the plan contains nearly 100 projects representing 20,000 hours of effort. She first explained the selection process, noting that 58 percent of the office’s time is committed before the annual planning process begins, with 34 percent encompassing projects performed each year due to legislative requirements, policy requirements, external regulations; 17 percent devoted to investigations; and 7 percent devoted to support activities, such as computer support and training. The remaining 42 percent of the office’s time is determined by a two-part risk assessment process, consisting of input from key university administrators and a structured examination of data on auditable units (budget size, number of financial transactions, management change, etc.).

Ms. Burns next explained the type of projects to be completed. Most of the office’s effort—43 percent—will be devoted to internal control audits, with the majority of these focused on controls in organizational units. Ms. Burns noted these were reviews requested by campus and institute chief business officers. Other types of projects for 2011 include investigations (17%); compliance audits (10%); consulting or efficiency/effectiveness reviews (7%); information technology audits (4%); financial audits (3%); fraud detection audits (3%); management support, such as providing training and serving on committees (6%); and office support activities (7%). Ms. Burns said a new initiative this year will be to examine invoices along with procurement card activity to provide a more comprehensive assessment of departmental purchasing.

Finally, Ms. Burns described the percentage of effort devoted to each campus and institute: University-wide Administration (33%), UT Knoxville (21%), UT Health Science Center (13%), UT Chattanooga (13%), UT Martin (11%), Institute of Agriculture (7%), and Institute for Public Service (2%).

Mr. Peccolo commented on the effectiveness of the procurement card program, with Internal Audit staff reviewing all transactions each month, representing about 10,000 transactions and \$2.5 million. Mr. Hickman noted the policy violations are relatively few compared to the number and volume of transactions.

Mr. Horne asked if Internal Audit was reviewing the Knoxville Athletics department’s expenditures and whether the department was being frugal. Ms. Burns replied that this year’s plan contained an audit to review the department’s business office operations. Mr. Horne asked whether the chancellors and institute heads were asked for their input on the plan, and Ms. Burns replied that they are, along with the chief business officers and other key administrators.

Mr. Gallimore asked whether any one location had more investigations than the others. Ms. Burns replied that this year the Memphis campus had a large number of investigations, which prevented completion of the audit plan. Mr. Paganelli noted that the number varies from year to year at each location.

Mr. Murphy motioned that the committee accept the 2011 audit plan as presented. Mr. Horne seconded the motion, and the plan was approved unanimously.

ACS Staffing Report – Ms. Burns presented an overview of Audit and Consulting Services’ current staffing levels. As of December 1, 2010, the staff consisted of 20.5 full-time equivalent (FTE) positions, with two vacancies. The 20.5 FTE include the following positions: 14.5 audit (including student workers totaling .5), 3 management, 1.7 support, and 1 compliance. The majority of the staff are located in Knoxville, with 3 FTE in Memphis, 1.83 FTE in Chattanooga, and .5 FTE in Martin. Ms. Burns noted that as of July 1, 2011, the FTE in Chattanooga will be reduced to 1.4, while the .5 FTE position in Martin will be eliminated.

Mr. Hall asked Mr. Paganelli to provide some historical information on staffing, who responded that staffing has historically been about 17 positions, which is in line with benchmarking he conducted with other institutions, as well as an often-cited rule of thumb that says an organization should have one auditor for every \$100 million in revenue.

Mr. Hall noted he was concerned about staffing levels, saying in difficult economic times there would be increased scrutiny on how government entities spent money, so this was a time to ensure adequate staffing. He added he asked Ms. Burns to consider preparing a letter from the Audit Committee to the chancellors asking them to provide funding from their budgets for positions that would focus on their campuses and help bring staffing up to adequate levels.

Mr. Hall asked whether benchmarks existed for appropriate IT staffing levels, and Mr. Paganelli and Ms. Cheek responded that they were not aware of any. Ms. Cheek stated she would research the issue.

Board Policy Change for Discretionary Reporting – Ms. Burns presented a proposed change to the Board of Trustees Policy Statement on Discretionary Expenditure Reporting for the President and Chancellors for the committee’s approval. She noted, as discussed at the November 4, 2010, Audit Committee meeting, the Higher Education Accountability Act of 2004 was amended in May 2010 to require only an annual (rather than quarterly) reporting on discretionary expenditures made by the president and chancellors to the Board of Trustees. The chief financial officer’s office plans to still collect and review these expenditures quarterly. If approved by the Audit Committee, the revised policy would be presented to the Board’s Finance Committee and approved by the entire Board of Trustees.

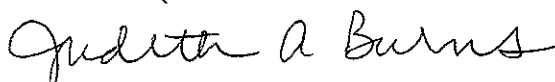
Mr. Hickman motioned that the policy change for discretionary reporting be changed. Mr. Gallimore seconded the motion, and the change was approved unanimously.

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

Exceptions in Travel Expenditures – Two minor exceptions were noted.

Housing Exception Report – No exceptions were noted.

Respectfully Submitted,



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