THE UNIVERSITY OF TENNESSEE BOARD OF TRUSTEES
AUDIT COMMITTEE
NOVEMBER 4, 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, Mr. Mark Paganelli, Mr. Charles Peccolo, Mr. Ron Maples, Dr. Jan Simek

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. Doug Horne, and the minutes were approved unanimously.

Mr. Hickman noted the minutes stated representatives of the UT Chattanooga and UT Martin athletics departments were to discuss their financial statements at a future meeting and asked if that was being planned. Ms. Burns stated those presentations would occur at a 2011 meeting.

Internal Audit and Audit Committee Charters – Ms. Judy Burns presented the internal audit and audit committee charters for discussion and approval. She explained that the recent external quality assurance review and the self-assessment done to prepare for the review revealed one area where Audit and Consulting Services did not comply with the Institute of Internal Auditors' (IIA) professional standards. Those standards require the chief audit executive to periodically review the internal audit charter and present it to the board for approval; similarly, the audit committee's charter states the committee will review its charter annually. The committee was therefore asked to approve both charters. The internal audit charter was last approved by November 2005; the audit committee charter was last approved in 2006.

Mr. Hall asked Mr. Mark Paganelli to give an update of the peer review. Mr. Paganelli noted that the IIA professional standards require an external peer review every five years. The last review was in 2005. Because Texas has a state law requiring such a review every three years, Mr. Paganelli asked the audit director of the University of Houston to head the 2005 review and the assistant director of the Texas Tech system audit office to head this year's review. This year's team also included audit directors from the University of Texas at Dallas, the University of Alabama system, and Tennessee Tech. Mr. Paganelli stated he likes to include someone from Tennessee on these teams because they understand our environment.

Mr. Paganelli observed that these teams essentially conduct an audit, interviewing the president, senior staff, and audit committee and reviewing audit work papers. He stated he has served on review teams and returned with ideas from the institutions reviewed since they face similar challenges. He said the only area of non-compliance identified by the review team was not presenting the audit committee charter to the audit committee annually. He explained that when the audit committee was formed, the first task was to create a charter. State auditors referred other state agencies to UT to obtain copies of the charter to use as a model. Then a law was passed requiring the state comptroller to approve all state agencies' charters. The comptroller's office required several revisions, including a provision that the audit committee be responsible for ensuring compliance with all laws and regulations. After much discussion about that and other revisions, the changes were made and John Morgan, who was then comptroller, approved the charter.

Mr. Hall asked whether any organization could provide education for the audit committee members for future meetings. Mr. Paganelli stated he has looked into possible IIA training or conferences for audit committees but had not identified any. He noted the IIA has materials available for audit committee members and that Audit and Consulting Services has begun work on an orientation guide for UT's audit committee. Mr. Hall stated the audit committee was created as a result of specific problems at the university and, as time passed, members would become less familiar with those problems and the committee's resulting responsibilities, so continuing education would be helpful. He then asked Mr. Paganelli and Ms. Burns to identify appropriate education and training.

Mr. Hall suggested holding the first audit committee meeting of 2011 in conjunction with the February board meeting in Chattanooga and hoped the new president would attend. Ms. Burns stated Dr. DiPietro had agreed to attend committee meetings once he takes office.

Mr. Crawford Gallimore motioned that the committee accept the internal audit and audit committee charters as presented. Mr. Hickman seconded the motion, and the charters were approved unanimously.

Changes to State Law Affecting Higher Education – Ms. Burns presented changes to state law that affect the operations of the internal audit function (Senate Bill No. 3680, passed in May 2010). The first change, to the Higher Education Accountability Act of 2004, limits reporting of expenditures from discretionary funds to the president and chancellors (eliminating reporting for the vice president of the Institute for Public Service and the head of the UT Space Institute) and changes the frequency of reporting those expenditures to the UT Board from quarterly to annually. Ms. Burns noted that the Treasurer's Office (Mr. Paganelli) will continue to collect reports on these expenditures from the relevant chief business officers quarterly. Mr. Paganelli confirmed this process, stating a Board policy must be revised to reflect these new requirements and is currently under review by the General Counsel and Secretary.

Dr. Jan Simek clarified that these changes to the law added no new reporting for any official; they either kept reporting requirements the same (as for the head of the Institute of Agriculture) or eliminated previous requirements (for the vice president of public service and the head of the Space Institute).

Mr. Horne asked who reviews the discretionary expenditures for the UC Foundation for reasonableness and appropriateness. Mr. Paganelli stated the university pays the bills and performs the accounting for the foundation so that the business office reviews the expenditures as they are processed and the auditors when auditing the UT Chattanooga's chancellor's office. Mr. Paganelli said the foundation funds provided to the chancellor are to be used at his discretion and expenditures are not questioned as long as they benefit the university. He noted that the UC Foundation members have an opportunity to raise questions because they receive the reports as well. Mr. Gallimore asked who decides to which account the expenditures are posted. Mr. Paganelli responded that, in this case, the chancellor decides. Dr. Simek stated it seems appropriate for the audit committee or the Board's efficiency and effectiveness committee to review such discretionary expenditures. Mr. Paganelli stated that, if the committee had questions or noted an expenditure that seemed excessive, it would be researched and the information reported to the committee.

Ms. Burns stated the second change in state law, to the Higher Education Financial Accountability Act, affects the workload of the internal audit operation more significantly than the first. The change reduces the requirement for auditing the offices of all UT senior executives each year to auditing only 30 percent of such offices annually, using a risk-based approach. This change, similar to that above, eliminates the need to audit the vice president of the Institute for Public Service or the head of the UT Space Institute. Ms. Burns informed the committee that, although not required, the plan is to continue to audit the president's office each year along with some of the chancellors' offices as identified in the risk assessment.

Revisions to 2010 Audit Plan – Ms. Burns presented revisions to the 2010 audit plan approved by the committee last fall. She stated this is not always done, but it has been a challenging year for the office regarding completing projects on the plan. The primary challenge has been significant employee turnover. Since the plan was approved, four staff members have resigned and two positions remain vacant, a management position and a staff auditor. Other challenges include staff illnesses and a large number of investigations, which must be completed as soon as possible. Ms. Burns then reviewed the plan, reorganized into the following categories: completed, to be completed by the end of 2010, begun but to be completed in 2011, carried over to 2011, and cancelled. She noted the reasons for the cancellations, including the previously discussed changes in state law, management changes, project no longer needed per management, and resignations of staff assigned to the lower priority projects. Ms. Burns indicated, however, numerous projects were added to the plan as a result of management requests. She reported that, despite the challenges, if the projected projects to be completed by year's end are accurate, the actual number completed will be comparable to last year.

Mr. Hall asked about the status of six departmental audits that were cancelled. Ms. Burns responded that an annual risk assessment is conducted to determine which areas will be audited and those six departments will be reassessed as the audit plan for 2011 is determined. She said, as a result of the risk assessment, those six could reappear on next year's plan or be replaced by other areas assessed as higher priority.

Mr. Hall also asked how the investigations are determined. Ms. Burns explained they result from calls to the state comptroller's hotline or to one of the internal audit offices; calls to business office staff or senior management; and letters or e-mails sent to Internal Audit, senior management, or even Board members. She noted claimants could be employees, students, or citizens and could choose to remain anonymous. Mr. Maples noted the audit committee receives a list of ongoing investigations each month.

Mr. Hickman stated, given the changes in state law requiring audits of 30 percent of the president's and the chancellors' offices, Internal Audit should have a plan to determine which offices will be audited each year so that, among other issues, the same third is not audited each year. Ms. Burns agreed, saying the office would work on that.

Mr. Gallimore asked who audits the university's financial systems, such as the accounts payable system. Mr. Paganelli replied that Internal Audit conducts such audits and the external auditor (State Audit) audits the university's financial statements. He explained that Audit and Consulting Services recently completed audits of large UT processes, including accounts payable (procurement cards and invoices). Payroll, accounts receivable, investments, and equipment have also been audited. The grants and contracts area was separated into several audits, including the largest grants and effort reporting. He added that the large process audits were sent to UT's controller and the chief financial officer for review and response. Ms. Burns noted the equipment audit was just completed and the report would be in the committee's packet for October.

Mr. Gallimore also asked if these audits included reviewing details of the workflow, such as separation of duties. Mr. Paganelli replied that the audits reviewed controls at a system-wide level and departmental audits reviewed controls such as separation of duties. Mr. Bill Moles, who performed the accounts payable audit, stated problems with controls were revealed at the departmental level. Mr. John Fox noted that most controls for accounts payable are at the departmental level. Mr. Ron Maples said, as a result of the audits, changes have been made to IRIS, the university's financial system.

Mr. Gallimore then asked whether the university had good controls over establishing vendors in the accounting system. Mr. Paganelli replied that the new law requiring Form 1099s to be issued to any vendor providing goods or services will strengthen controls. He stated currently university departments can establish one-time vendors, which concerns auditors, but noted a one-time payment cannot be processed for $5,000 and above. Mr. Maples stated the process for creating a vendor has been limited to two people. Mr. Gallimore suggested that vendors be researched on the internet to ensure they are legitimate. Mr. Paganelli agreed to follow up.

Mr. Hall asked about the number of audit staff and their location. Ms. Burns replied there are 16.5 auditor positions (plus the executive director), with 3 employees in Memphis, 2 in Chattanooga, 11 in Knoxville and a half-time employee in Martin. She noted the half-time position will likely be eliminated July 1, 2011, when federal stimulus funding ends, and one employee in Chattanooga will revert to 40 percent time on that date.

Mr. Gallimore asked whether the remaining positions would survive budget reductions this coming year. Ms. Burns said if budgets are reduced by 3 percent, as Governor Bredesen has suggested could happen, one position would have to be eliminated.

Mr. Hall asked whether the existing number of staff is sufficient to fulfill the department's responsibilities. Ms. Burns stated additional resources were needed for the compliance function and for performance auditing, a new service Mr. Hall would like the office to add. Ms. Burns said she had requested a budget increase from Mr. Charles Peccolo, who agreed to try to fund two additional positions for each of the next two fiscal years. One would be devoted to compliance and performance auditing each year.

Mr. Paganelli said 17 staff members is typical, but that number has decreased over the years from around 18. Ms. Burns noted some campus chief business officers, including Martin where the half-time position will likely be cut, have expressed interest in increasing audit coverage for their campuses. Mr. Paganelli explained that the business officers are concerned because many of the financial controls are at the department level and audit resources used to be devoted to departmental audits. Since the formation of the audit committee, however, he said resources have been used to review large processes, such as accounts payable and payroll, and to efficiency audits.

Dr. Simek stated UT administration is interested in finding resources to assist in this area. The university currently does not have a group focused on process efficiencies, so he has turned to Internal Audit. He noted that, as Mr. Peccolo reorganizes the financial area, he would look for funds to reallocate. He stated he would discuss the issue with Dr. Joe DiPietro.

Institutional Compliance – Mr. Moles gave an update on the institutional compliance program, including the current strategic plan for adding staff, preliminary results of the UTK compliance risk assessment, the plan for performing the risk assessment at other campuses and institutes, and the plan for launching the new Code of Conduct.

The current plan, with available funding, is to add one position at the beginning of fiscal year 2012,with a similar position added the following fiscal year. The first position will be located in Knoxville and have responsibility (with the director's assistance) for UT Knoxville (UTK), UT Chattanooga (UTC), Institute for Public Service (IPS), UT Space Institute (UTSI), University-wide Administration (UWA), and the Institute of Agriculture (UTIA). The second position will be located in Memphis and be responsible for the UT Health Science Center (UTHSC) and UT Martin (UTM).

These positions, titled institutional compliance officers, will be responsible for directing campus compliance efforts, coordinating compliance information among campuses, performing audits in high-risk areas, and implementing the Code of Conduct and the proposed compliance hotline awareness program.

Mr. Moles proposed that each campus and institute form a compliance committee, for which his office would provide substantial direction and support. The committee, composed of compliance officers in critical areas, would report to the campus chancellor/institute vice president. The committee would be responsible for analyzing data gathered in the compliance risk assessment and identifying priorities; ensuring that corrective action plans are developed, appropriate, and implemented; and identifying where resources or other assistance is needed.

Mr. Moles stated at UTK, 400 regulations have been identified; 72 compliance officers have been assigned; the risk assessment is almost complete; and the chancellor is in the process of naming a compliance committee chair. Regarding other units, the risk assessment process for UTIA has begun (due to its overlapping responsibilities with UTK). This will be followed by UTHSC (hopefully starting by July 2011), then UTC, UTM, IPS, UTSI, and UWA.

Mr. Moles announced a new Code of Conduct will be launched on January 1, 2011. He explained he initiated several significant changes to the existing code to bring it into compliance with the requirements of the *Federal Sentencing Guidelines for Organizations*. Changes include a stipulation that employees must comply with all regulations and internally report instances of noncompliance. New employees will be instructed at orientation to read the code and sign an online acknowledgement; current employees will be informed of the code through an awareness campaign and will receive annual reminders.

Mr. Jim Murphy asked if the office was confident the entire regulatory universe had been identified. Mr. Moles responded that defining the universe was an ongoing process, with his office giving the compliance officers a starting point and asking them for feedback and additions. As a result, some regulations were dropped and some added and the list would continue to be refined.

Capital Projects Report – Mr. Fox presented a summary of the capital projects review performed at the request of Dr. Simek to address concerns raised by the chancellors. The primary concern was the delay between funding being approved and a project starting, sometimes spanning several years. Other concerns included the requirement to obtain State Building Commission (SBC) approval for all projects above $100,000, inadequate oversight of construction and financial information at the campuses, and lack of adequate monitoring of construction by Facilities Planning.

Mr. Gallimore asked how long the $100,000 threshold had been in effect. Mr. Fox and Mr. Paganelli responded quite some time [apparently since 1978]. Ms. Burns noted discussions are underway about raising that amount. Mr. Horne asked whether the SBC raised questions about projects, and Dr. Simek responded they usually gave approval and the problem was primarily the steps needed to obtain approval.

Mr. Fox said the review revealed the delay was primarily due to the facilities program, the detailed instructions for the architect, often not being completed until after the legislature had approved the project and funding received. This situation results in many decisions needed after legislative approval, including retrofitting expectations to conform to the budget.

Mr. Murphy noted this should not be the case. Mr. Gallimore asked why it took so long to complete the program. Mr. Paganelli said the problem was getting people involved to make decisions. The suggestion was made to not seek funding until a program was completed. Mr. Hall asked whether there were enough staff to complete the programs. Mr. Paganelli agreed that was a problem, with only 13 professionals on the Facilities Planning staff to work with the campuses. Dr. Simek noted the campus was responsible for the program with oversight and advice from Facilities Planning.

Mr. Fox noted several reasons why facilities programs were not completed timely: campuses lack the expertise; Facilities Planning lacks adequate staff; and no senior system-level official champions the process. Mr. Paganelli noted the architectural firm that consulted on this review agreed that staffing was insufficient. Dr. Simek mentioned the possibility of adding the cost of a project manager to the funding request. Mr. Murphy asked whether the SBC would allow it, and Mr. Paganelli responded the idea should be explored.

Mr. Fox summed up the review's recommendations: require program completion before requesting Board of Trustees approval, increase capital projects staff, consider locating staff at the campuses, determine reporting structure for project managers, consider a project fee to fund managers, formally designate campus representatives, update master plans, and provide financial information to the campuses.

Mr. Peccolo said he has created two ad-hoc committees to address the recommendations, one to address management information/financial reporting and one to address the organizational structure of the capital projects function. Mr. Hall asked if these reports could be discussed at the next audit committee meeting, and Mr. Peccolo agreed.

Revisions to the University's Financial Risk Assessment – Ms. Burns presented updates to the university's financial risk assessment. She noted the audit committee charter requires the committee to review management's risk assessment. The primary revisions to the risk assessment involved adding risks and controls related to managing the American Recovery and Reinvestment Act (ARRA) funds provided by the state and the federal government. Risks and controls were also added for IRIS, the university's financial and human resources system. Ms. Burns described how Internal Audit was following up on the risk assessment. First, audits of the ARRA funds are underway at each campus. Second, the large process audits involve areas addressed in this assessment, including the recently completed equipment process audit which used the risks and controls identified by the Controller's Office staff during the risk assessment process. Finally, she noted Audit and Consulting Services conducts an annual self-assessment of controls, in which 500 UT departments are asked questions about two key areas included in the risk assessment.

Mr. Hall asked whether the risk assessment process was working as expected, and Mr. Peccolo replied that it was.

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

Exceptions in Travel Expenditures – Three minor exceptions were noted.

Housing Exception Report – No exceptions were noted.

Respectfully Submitted,

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The University of Tennessee