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University of South Carolina

BOARD OF TRUSTEES

Audit and Compliance Committee

March 18, 2011

The Audit and Compliance Committee of the University of South Carolina met on Friday, March 18, 2011 at 1:00 p.m. in the Hampton Street Board Room.

Members present were: Mr. J. Egerton Burroughs, Chairman; Mr. Chuck Allen; Mr. W. Lee. Bussell, Sr.; Dr. C. Dorn Smith, III; Mr. Thad H. Westbrook; Mr. Mack I. Whittle, Jr.; Mr. Charles H. Williams; Mr. Miles Loadholt, Board Chairman; and Mr. Eugene P. Warr, Jr., Board Vice Chairman.

Other Board members present were: Mr. Thomas C. Cofield; Dr. C. Edward Floyd; Mr. Toney J. Lister; and Ms. Leah B. Moody.

Others present were: President Harris Pastides; Secretary Thomas L. Stepp; Vice President for Academic Affairs and Provost Michael D. Amiridis; Chief Financial Officer Edward L. Walton; Vice President for Student Affairs and Vice Provost for Academic Support Dennis A. Pruitt; Vice President for Human Resources Chris Byrd; Vice President for Information Technology and Chief Information Officer William F. Hogue; Vice Provost and Executive Dean for Extended University Chris P. Plyler; Chancellor of USC Aiken Thomas L. Hallman; Dean of USC Sumter C. Leslie Carpenter; Vice Provost and Dean of Undergraduate Studies Helen I. Doerpinghaus; Associate Vice President for Business and Finance and University Budget Director Leslie G. Brunelli; Associate Vice President for Facilities Thomas D. Quasney; General Counsel Walter (Terry) H. Parham; Director of Capital Budgets and Financing, Division of Business and Finance, Charles D. FitzSimons; Chief Financial Officer, Department of Athletics, Jeff Tallant; Director of the Department of Internal Audit Alton McCoy; Associate Vice President for Information Technology and Deputy CIO Jeff Farnham; Vice Chancellor for Business and Finance, USC Aiken, Ginger S. Hudock; Associate Vice President for Transportation and Logistical Relations Derrick Huggins; Director of Financial Planning, Controller's Office, Mary Peak; University Bursar Janis B. Hoffman; Administrative Coordinator, Office of Business and Finance, Heather Winkleman; Chair of the Faculty Senate Patrick D. Nolan; Special Assistant to the President and Director of Athletics John D. Gregory; Special Assistant to the President J. Cantey Heath, Jr.; Consultants from Elliott Davis, LLC, Tom McNeish and Brian Damico; Director of Governmental and Community Relations and Legislative Liaison Shirley D. Mills; Director of Governmental Affairs and Legislative Liaison Casey Martin; Director of Media Relations, Office of Communications, Margaret Lamb; University

Technology Services Production manager, Justin Johnson; Board staff members Terri Saxon, and Vera Stone; and a member of the media.

Chairman Burroughs called the meeting to order, welcomed those present, and asked those in attendance to introduce themselves. Ms. Lamb introduced a member of the media who was present.

Chairman Burroughs stated that the agenda had been posted and the press had been notified as required by the Freedom of Information Act; the agenda had been e-mailed to the Committee members; and a quorum was present to conduct business.

Open Session

I. Audit Tracking Report: Chairman Burroughs called on Mr. McCoy to present the Audit Tracking Report. Mr. McCoy reported that there were a few items that were still outstanding and had not been resolved.

The first was Human Resources. The University has replied to the IRS in response to its questions pertaining to our request for a private letter ruling on the Prudential matter. It is hoped that the response from the IRS will be forthcoming in the near future. Mr. McCoy noted that we have the names of approximately 1,800 people who would receive refund checks and, out of those, we have located and had correspondence with all but a few; also we have found almost everyone and, primarily, we have found those who would receive significant refunds. The situation should be resolved by the end of the summer.

Mr. Whittle questioned the wisdom of putting the University in the position of providing tax advice to individuals. Mr. McCoy responded that the committee working on that will not provide tax advice; we will reinstitute the insurance and annuities committee to go over all benefits available to programs and make sure that what we are doing is proper and review all these matters under the direction of the new Vice President for Human Resources. New software to be available July 1 would assist them in their work.

The other pending matter was Payroll. Liability accounts were not properly reconciled in all cases. We are advertising jobs for new employees with expertise in this area and that should bring this matter to conclusion.

The other audit tracking matter was in Accounts Receivable; there were still some items and they are developing new policies in those areas. So, other than that, every item on the tracking report seems to be in real good shape and we should have everything taken care of in the very near future.

Chairman Burroughs declared the report was received as information.

II. Internal Audits: Chairman Burroughs called on Mr. McCoy to present the following internal audits:

A. Student Fees and Refunds: The first audit dealt with Student Fees and Refunds. There were two findings that needed clarification. The first was the Military Fee in our schedule of fees for students. This fee is actually the tuition rate that we charge at our two year campuses, but active military get to utilize that rate no matter what campus they are attending. There was confusion as to how the rate should be applied and if military dependents were eligible. State law says anyone stationed in South Carolina is eligible for in-state tuition rates. The rate needs to be clarified and set by the Board. The department is working on a clarification to resolve these questions.

The second finding in the student fees office had to do with credit card reconciliation. We have accounts where people pay through the internet. It was formerly considerably out of reconciliation but after a lot of work it is now down to just a small difference and they will hopefully get that resolved in the near future.

B. USC Aiken Office of the Vice Chancellor for Business and Finance: The other audit is the USC Aiken Campus Business and Finance Office. During the audit some shortages were found and lack of receipts in the student dining area. The food service contract is with A.R.A. Our commission is based on what they sell. In our case we were getting commissions based on funds that went through student cards but there was a dishonest employee involved and all cash sales did not get processed properly. A.R.A. has its internal auditors on campus now and they are going to verify all receipts for the last three years and make sure everything is correct and settle up properly with the University and apologize for the errors.

The other finding dealt with the Children's Service Center. This day care center is a departmental activity but the director's salary is charged through an "A" fund, which is appropriated money. The salary should be charged proportionately to accounts according to what people do in different jobs. An activity such as the child care center should reflect all the revenues and expenses associated with that activity. The appropriate amount of salary devoted to the center should be charged to the "E" account associated with it. Dr. Hallman stated that he agrees in principle with the finding and has made adjustments through the years and will continue to make adjustments. However, there is a broader value to the University and the community of having the only nationally accredited day care center in Aiken County. There is good will for the entire University that arises from having the facility and having the ability for community folks to take advantage of it and the campus truly believes that there is probably a point at which it does make sense to appropriate some "A" fund dollars in that direction. Dr. Hallman agreed that Aiken needs to continue to reduce the payment from its present level.

Mr. Walton commented on the good working relationship with Internal Audit on all these issues and the value of a good professional working relationship to put these

issues from the past behind us. Mr. Burroughs said we want to keep following this pattern and make sure that everyone is working together.

III. Report of Financial Statement - Department of Athletics: Mr. Walton was called on to report on the Department of Athletics Financial Statements. He asked if Mr. McNeish could first report on the audits of the Athletics Department and the Horizon and Discovery Garages.

Mr. McNeish reminded the committee that these were financial statement audits and the primary objective of that is to perform certain procedures to determine whether or not the financial statements are presented in accordance with Generally Accepted Accounting Principles. This provided credibility for the users of the statements. He stated that the auditors also look at the internal controls. When they come across an internal control issue in the course of examining the financial statement, they are required to report those.

He stated that he would not go into any more details on the numbers contained in the statements unless there were questions. He would talk briefly about essentially the process they followed and where a risk is with a given audit. He further stated that they concluded that there was an unqualified opinion on the financial statements under discussion.

He noted that in these audits, based on examination of information from the University's general ledger, that essentially they are breaking out relatively small parts of the University's overall financial record keeping and thus examinations are at a much more specific, finer level than when they audit the University as a whole.

With respect to the Athletics Department, he stated that their biggest concern is the timing of the dollars and when they come in. For example, large sums will come in for the purchase of season football tickets leading to what they refer to as deferred revenue. They only recognize those funds as revenue to the extent the season is completed. Thus, internal controls are an important consideration, and as it relates to the Athletics Department in this instance, there are no reportable findings in terms of significant deficiencies or material weaknesses. This should be considered a positive as it relates to these accounts. As to the financial statements themselves, the report is unqualified, meaning that based on the audit tests that were performed, their opinion as our independent auditors is that the financial statements were presented fairly and in accordance with Generally Accepted Accounting Principles.

The audit of the Horizon and Discovery Parking Garages for 2008 and 2009 is a new audit, compared to the Athletics audit which has been conducted annually for many years. The Board has been informed about the background for conducting this audit. The objective of the audit overall was to give their opinion as to whether or not those financial statements are presented fairly in accordance with Generally Accepted

Accounting Principles. These financial statements provide the information the University needs to manage the situation with the garages and the fact that current parking revenues are not sufficient to make required debt payments. The statements are also of importance to the funding source for the loan in terms of wanting to analyze USC credit to see where they are from a cash flow perspective. They obviously are interested in knowing how the operation of the garage is working with respect to cash flow. Mr. McNeish reminded the Committee that these statements are at a point in time and the situation has changed since these audits were performed. The audit for June 30, 2010 will begin in the near future. The prior years needed to be audited first to provide a "good jump off point." As far as the financial statements themselves and their presentation, the auditors issued an unqualified opinion.

In response to a question from Mr. Whittle, Mr. Walton stated that now the annual shortfall in operating the garages is about two million dollars a year, but it projected to decrease each year and be eliminated in seven years.

Mr. McNeish repeated that in the review of internal controls if there is a significant deficiency or material weakness, they are required to report that. He stated, "We didn't note anything of that severity. However we did note and reported to you in an internal control letter what we would consider control deficiencies. I would say none of these are from an audit standpoint considered 'red flags.' They are items that we want management to be aware of. They are items that, when we come back to the audit for 2010, we will follow up on. Management has responded to each of these; we are encouraged by the response." He reported that it looks like a number of these items have already been at least started to have been addressed. The main risk is the receipts and revenues and making sure that there is proper safekeeping and proper reporting of those.

Mr. McNeish reported that in the past he has discussed best practices and internal controls with management and the committee. There is a separate letter which refers to these. Primarily, they revolve around the proper segregation of duties. An employee who initiates a transaction should not be the one who is recording that in the general ledger. Somebody should be coming behind that employee from a supervisory standpoint, reviewing what was done, and making sure it was appropriate and for a proper purpose.

IV. Whistleblower Policy Draft: Chairman Burroughs called on Mr. Walton to present the Whistleblower Policy Draft. Mr. Walton thanked Vice President Byrd for his work in formulating the policy. He described a whistleblower as someone who has an exception with the way the University is managed and insure them a free and safe way to express their concerns and then be assured of a reply. A draft document has been circulated to the Committee. Mr. Walton suggested that all members study the draft as it continued being finalized within the University with the idea of adopting a final policy at the next meeting.

Mr. Byrd reminded the Committee that all state employees already have protection within state law for reporting mismanagement and instances of violations of state or federal law. At Carolina, what our employees do not have is a real clear process for reporting perceived violations within the University. The proposed draft policy includes three major elements: first, a proposed procedure for reporting violations; second, a clear outline of the responsibility of the whistleblower themselves; and, third, protections an employee will receive in the event that they report such a violation. All complaints, their status, and any resolution will be reported to this Committee on a quarterly basis.

A variety of discussion followed and Chairman Burroughs declared the draft policy accepted for information with the intent of adopting it at the next meeting.

V. Internal Control Policy Draft: Similarly, Mr. Walton presented the Internal Control Policy draft which was accepted by the Committee for information and action at its next meeting.

VI. Audit and Compliance Committee Planning Matrix Through 2011: Chairman Burroughs called on Mr. Walton to present the Audit and Compliance Committee Planning Matrix. He described that the Matrix is derived directly from the Charter, as adopted by the Committee at its last meeting. The objective is to establish a way for financial management and audit management to communicate with the Audit and Compliance Committee. The matrix lists a set of duties as one axis and dates for action as the other. It makes clear the large responsibility and work load of the Committee and its members. Mr. Burroughs asked for approval of the Matrix, recognizing that details will often be changing, that the Committee retreat needs to be added. The scope of the work will be known to all members as well as the schedule of time frames for completing various responsibilities. Mr. Whittle suggested that the annual date for Board members to complete conflict of interest forms should be added. Such a policy would apply to the whole University and this Committee would receive reports of any filings indicating a conflict.

Mr. Walton pointed out that the Matrix is based on the Charter and suggested the two items be adopted simultaneously.

VII. Approval of Audit and Compliance Committee Charter: Mr. Walton discussed the history of the development of the Charter for the Committee which came out of the last retreat and was presented as a first draft last December. The Committee generally agreed to the terms at that time. The staff took it and put it into a business format. It has been for review. It is a work plan for the Committee which contains a great deal of detail. It would always be subject to being adapted to times, needs, and circumstances. The Charter is similar to others across the country and many of the things in it are

being done, but it organizes and explains in the compliance areas what the University is doing and brings that to the Committee in a formal way.

Chairman Burroughs reminded the Committee that the matrix is always being updated and at least once a year the Committee will review, update, and discuss the Charter and send it to the Board for approval.

Mr. Whittle moved and Mr. Williams seconded that the Charter proposed for the Committee and the Matrix that goes with it be approved by the Committee. The Charter will be forwarded to the Board for approval at its next meeting. Mr. Burroughs called for a vote and the motion was adopted unanimously.

Mr. Burroughs thanked all who had worked on the Charter. He noted that Darla Moore had contributed and worked on this project as well as many others and recommended that this Committee send her a letter thanking her for her long service on this Committee and her hard work through the years.

VIII. Amend the FY10-11 Designated Funds Budget: Mr. Walton discussed ways to improve further the presentation of the budget process and the draft budget to the Board in June. Some members want more information. Leslie Brunelli suggested a process to explain more how items work into the budget. We currently provide a lot of information but this year we may have extra sessions with the Executive Committee: the first to explain why the budget looks like it does (how we put it together) and the second to study what we think the FY12 budget will look like more in terms of specifics and likely dollar amounts. The legislative budget cut to date is less than we had anticipated, although we are losing another \$7.3 million dollars. This will still bring our total cut up to \$112 million per year since FY 08.

Mr. Walton offered a follow up to the Davis-Bacon Act. The last time we met, Elliott Davis reported that with respect to our federal funds, we did not comply completely with that Act that states that if you receive federal funds and build a capital project with those funds you are required to use the prevailing wage rate. There are regulations dictating records be kept to prove that you did comply with the act. The University at the time did not have all of those records for all projects; we have since gained those records. Elliott Davis will certainly be testing this item when they get in the field this spring. We will show them the records and that we do have that. Meanwhile, we are preparing for our Stimulus Act audit, which is ongoing. There were some exceptions but we think all of those records are now in place and 100 percent under control.

Mr. Walton then reported about two items of technical default on debt discussed at our last meeting. One was at the School of Medicine Educational Trust; they had not met their asset to debt ratio requirement so they were in technical default with their lender Wachovia/Wells Fargo. This was a management cash flow matter; they have made the

adjustments; they no longer have a technical default. We were also in technical default on the borrowing for the two parking garages discussed earlier in the meeting. That default may not be remedied for at least seven years when we plan to collect enough parking revenue to pay the debt. We have asked the lender, BB&T, to consider the fact that even though we don't have parking garage revenue, the fact that the University is paying the debt should get them to overlook or waive the technical default. This is having no negative effect on our credit. We are aware of it and working toward a solution. We will continue to keep the Board informed.

Mr. Walton briefly commented on the way the new internal auditor will report to the Board.

Further, Mr. Walton presented to the Committee a comprehensive workbook that contains the materials, practices, policies, background reports and other matters that the Committee can use at all times as a reference work for performing the job of being a member of this Committee. He thanked Mr. McCoy for his work on this first draft, which will be under continuous improvement and a background handbook for reference with respect to the Committee Charter and matrix. All members of the Board will be given a copy.

Mr. Walton then provided an update on the Biomass plant. It is under repair. The important point is that our partner and the University are committed to adhering to the requirements of the contract. The contract requires either payment to the University or guaranteed minimum performance. Johnson Controls is preparing to pay the University the effect of the guaranteed savings that have not been achieved through the plant in cash. This first check will be for \$4.1 million but it also makes them committed to making the plant function as intended as a commercial grade plant.

Mr. Tom Quasney reported to the Board on the engineering and operational activities of the recent past and his optimism about its future. The teamwork with JCI has been important in forging a way forward. It is now operational, although there are still frequent problems. The solutions are in both a short term plan and a long term plan. The plant recently had its most successful operating period, running for 24 consecutive days producing 40,000 to 50,000 pounds per hour. We are three years behind schedule but are being paid for the services we are not receiving - we are saving the costs just as though the plant was operating successfully.

IX. Department of Internal Audit Search Committee Report: Mr. Burroughs called on Chairman Loadholt for an update on the Internal Audit Search Committee. He stated that the Committee is talking to several candidates, after having interviewed nine of them, and that the Committee expected to complete its work "in the next couple of weeks." Mr. Burroughs thanked the Committee for its hard work and expressed his feeling that although time consuming, it had been a worthwhile effort from which all the members had learned a great deal.

X. Other Matters: Chairman Burroughs called on Mr. Walton who gave a report on a list of follow-up items from the last meeting. He began by asking Dr. Hogue and Dr. Carpenter to give an update on the Sumter Campus computer security breach. Dr. Hogue noted the sensitivity about discussing computer security publicly. He discussed the importance of the national epidemic of IT security issues, affecting the whole country. In the last six months, IT discovered 1,867 faculty and staff computers that had some form of virus and another 182 that had some form of spyware. The numbers for students are even higher because the use of computers by students is generally more casual. Nearly 10,000 faculty, staff and student computers at Carolina have had some sort of intervention in the last six months. Automated intrusion detection sensors on the University's computer network shows that we have been attacked over 105,000 times since April of 2010. We have strong data management and data security policies. Data Trustees throughout the organizational structure have additional responsibility for data security which ultimately rests with the IT Division. Materials on these policies and systems have been distributed to the Board.

In Sumter, the exposure was discovered in the end of January and the server was taken off line within a couple of hours. The analysis began the next day. The University informed persons potentially affected in letters sent on February 10 and February 28. Analysis of files is still ongoing to ensure that the effort is comprehensive. The next steps include that the Data Trustees have initiated a review; the University has secured the services of an external expert to advise on strengthening IT security; and we are working on a contract with a private firm to be on standby to assist us when there is a problem that requires an injection of time and effort beyond our internal capacity as well as assist us with prevention efforts. And, intensive user education will remain a priority effort.

Mr. Whittle asked about policies and procedures in place. Dr. Hogue assured him they were comprehensive but very private. Mr. Whittle suggested the possibility of an IT audit by an external firm to help us search for any weaknesses. Dr. Hogue responded that he would be "thrilled" with that approach.

Chairman Burroughs asked how the incident in Sumter happened. Dean Carpenter responded that it was a human error. A server that should have been purged had not been purged. Measures are in place to prevent this from happening again. Mr. Allen asked about what corrective measures were implemented. In responsive to a question from Mr. Whittle, Dr. Hogue responded that he has a great deal of data from other universities and will report further to the Board.

Chairman Burroughs called for a motion to enter Executive Session to discuss a contractual matter related to professional services contracts. Mr. Williams so moved and Mr. Allen seconded the motion. The vote was taken and the motion carried.

Chairman Burroughs invited President Pastides, Secretary Stepp, Dr. Amiridis, Mr. Walton, Dr. Pruitt, Dr. Hogue, Mr. Parham, Mr. Byrd, Ms. Lawrence, Ms. Dodenhoff, Dr. Plyler, Mrs. Hanna, Ms. Brunelli, University Chancellors, Mr. Heath, Mr. McCoy, Mr. McNeish, Mr. Gregory, Mrs. Martin, Ms. Mills, Mr. Farnham, Dean Carpenter, and Mr. Quasney to remain.

Return to Open Session

Chairman Burroughs called for a motion to amend the FY 2011 Designated Funds Budget by increasing the funds in the category of Finance and Planning by \$150,000.

Mr. Westbrook so moved and Dr. Smith seconded the motion. The motion was adopted unanimously.

There being no further business to come before the Committee, Chairman Burroughs declared the meeting adjourned.

Respectfully submitted,

Thomas L. Stepp
Secretary