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University of South Carolina
BOARD OF TRUSTEES

Fiscal Policy Committee

December 7, 2010

The Fiscal Policy Committee of the University of South Carolina Board of Trustees met on Tuesday, December 7, 2010, at 2:00 p.m. in the 1600 Hampton Street Board Room.

Members present were: Mr. J. Egerton Burroughs, Chairman; Mr. Chuck Allen; Mr. W. Lee Bussell, Sr.; Mr. Thad H. Westbrook; Mr. Mack I. Whittle, Jr.; and Mr. Miles Loadholt, Board Chairman.

Members absent were: Ms. Darla D. Moore; Dr. C. Dorn Smith III; Mr. Charles H. Williams; and Mr. Eugene P. Warr, Jr., Board Vice Chairman.

Ms. Leah B. Moody was also present.

Others present were: President Harris Pastides; Secretary Thomas L. Stepp; Vice President for Academic Affairs and Provost Michael D. Amiridis; Vice President of Finance and Planning and Chief Financial Officer William T. Moore; General Counsel Walter (Terry) H. Parham; University Treasurer Susan D. Hanna; Associate Vice President for Resource Planning, Division of Finance and Planning, Edward L. Walton; Associate Vice President for Finance and Budget Director, Division of Finance and Planning, Leslie Brunelli; Director of Governmental and Community Relations and Legislative Liaison Shirley D. Mills; Director of the Department of Internal Audit Alton McCoy; Director of Financial Reporting Mary Peak; Director of Media Relations, Division of University Advancement, Margaret Lamb; Special Assistant to the President J. Cantey Heath; External Auditor Tom McNeish and Attorney Brian D'Amico of Elliott Davis, LLC; University Technology Services Production Manager, Justin Johnson; and Board staff members Vera Stone and Karen Tweedy.

Chairman Burroughs called the meeting to order, welcomed everyone, and asked Board members to introduce themselves. Ms. Lamb stated that there were no members of the media present.

Chairman Burroughs stated that notice of the meeting had been posted and the press notified as required by the Freedom of Information Act; the agenda and supporting materials had been circulated to the Committee; and a quorum was present to conduct business.

I. Presentation of External Audit of Financial Statements for June 30, 2010:

Chairman Burroughs called on Mr. Tom McNeish, External Auditor, who gave an overview of the process used in reviewing the University's financial statements for the fiscal year ending June 30, 2010.

The following three sets of standards were used: 1) Generally Accepted Accounting Principles (GAAP); 2) Yellow Book (Government Auditing Standards); and 3) the Single

Audit Act which was a separate audit and was related to federal expenditures. This year, because of the American Reinvestment Act, the University had received approximately \$450 million in federal grants which was a substantial increase.

Mr. McNeish opined that the Financial Statements were fairly presented in accordance with GAAP.

He stated that Research and Development Grants and Financial Aid were the two primary federal funding sources to the University. Under the Single Audit Act, the auditors were required to determine what the University's major programs were and conduct a search to look at their record keeping to be sure the institution was in compliance with federal standards for particular grants. If the University was not in compliance, the government could request refunding of the money.

Mr. McNeish reported that there were four audit findings which were basically classified as a deficiency in internal controls and/or material weaknesses.

The first two audit findings dealt with Parking Facilities (parking garages) and the Prudential Insurance Demutualization. He stated that these two findings had already been identified by the Administration and the internal auditors; and that corrective action had been taken.

During fiscal year 2008, the University had entered into an agreement to construct, operate and manage two parking facilities. In fiscal year 2010, the University determined that based on the terms of the agreement, the facilities met certain criteria to be capitalized as University capital assets under GAAP. The cost of the facilities had not previously been capitalized by the University. The University reported this determination to its independent auditors and proposed an adjustment of \$9,788,231 million to restate prior year net assets. Auditing standards would indicate that this restatement should be reported as a material weakness.

The external auditors recommended that the University should continue to effectively evaluate complex transactions in order to determine proper reporting treatment in accordance with GAAP. Such evaluations should be completed within a timeframe that would prevent future restatements.

The second audit finding involved Insurance Demutualization. Beginning in 2001, the University's personnel department began receiving shares of stock and dividend checks resulting from the demutualization of an insurance company that provided certain employee benefits to the University. From 2001 until 2010, these items were maintained in a safe in the personnel department, including the dividend checks which were not recorded in the University's general ledger during this period. These conditions surfaced during 2010 as the result of an internal audit of the personnel department.

Mr. McNeish stated that the auditor's recommendation was that in the event that an individual or department received any form of consideration including (but not limited to) cash, checks, stock certificates, ownership interest, or donations of goods, services, or real property, on behalf of the University, these transactions should

immediately be communicated to the University's controller. In addition, all documentation related to these transactions should immediately be forwarded to the controller's office for evaluation to determine proper accounting procedures and timely reporting.

The third audit finding addressed the University's failure to demonstrate compliance with the Davis-Bacon Act. He stated that the Davis-Bacon Act required the grantee to obtain from the contractor, for each week in which any contract work was performed, a copy of the payroll register and a written certification to demonstrate compliance with prevailing wage rates. The University, in six instances, was unable to provide payroll registers and certifications to demonstrate compliance with the provisions of the Act.

The auditors recommended that the University implement a process to ensure proper paperwork compliance with the provisions of the Davis-Bacon Act.

The fourth audit finding involved noncompliance with Section 1605: Buy American. The auditor recommended that the University implement a process to ensure proper paperwork compliance with the provisions of Section 1605.

Mr. McNeish stated that the Administration had already addressed a majority of the findings or was in the process of addressing them. Therefore, he expected the University to be in compliance during a follow-up visit.

It was determined that these findings could be added to the University's tracking report so the committee could be kept apprised and to ensure compliance.

Chairman Burroughs inquired about the unrestricted net assets in the financial statements. Dr. Moore responded that a substantial amount of those funds were committed and elaborated on them.

Chairman Burroughs thanked Mr. McNeish for his presentation.

II. Presentation of Financial Analysis of Financial Statement Information for June 30, 2010: Chairman Burroughs called on Dr. Moore who responded to the independent auditor's findings on behalf of the administration.

Dr. Moore stated that the administration appreciated the independent auditor's recognition that the reported conditions regarding the garages had initially been identified by the University and the administration had already provided a remedy. The mistakes had been addressed with management personnel changes and renewed focus on internal controls of financial transactions and financial reporting. Dr. Moore believed the University's system of internal control had improved as a result of this audit and other work from this committee. He was confident that the restatements of prior year balances now properly reflected the transactions.

Dr. Moore made the following remarks as it related to the four audit findings:

A. Innovista Parking Garages - Finding #1: He made two statements regarding accounting and technical default.

Accounting - In 2008, the University and the Columbia Parking Facilities

Corporation entered an agreement which stated that the Corporation would provide the University approximately \$30 million for the construction of the Horizon and Discovery Garages on land owned by the University. The deal was constructed to be an "off balance sheet" debt of the University. The University accepted ultimate responsibility to pay debt service, in writing, thus generating a liability. But the University did not own the asset (garages), so the balance sheet could not balance under the original agreement terms. Acceptance of financial responsibility required that the University bring the transaction onto the University balance sheet, thus triggering the restatement.

Dr. Moore advised that the Administration had carefully explained the circumstances to Moody's and they had determined that the restatement did not give rise to a review of the University's credit rating.

Dr. Moore thanked Mr. Whittle and Barclays Capital for their guidance and advice during that process.

Technical default - Dr. Moore stated that this was not an audit finding but a serious issue arising from the same transaction. He said if parking receipts were less than monthly debt service requirements, the University was required by the terms of the agreements to use its "best efforts" to locate sources to provide the additional funds required to satisfy all such obligations. Parking revenues had not adequately covered the debt service requirements. To date, the University had funded all monthly shortfalls with institutional funds.

As of June 30, 2010, the University had advanced \$496,000 in operating expenses and \$2.275 million in debt service from institutional funds. These transactions were processed as advances from the University with the expectation that future revenue would repay the advances.

Currently, the University was in negotiations with the debt holder (BB&T) to obtain a waiver of the default. The Associate Vice President for Transportation and the Director of Capital Finance had developed a parking and financing plan that would generate the revenue required for debt service and would repay these advances in approximately seven years.

Dr. Moore stated that the University would prevent these kinds of problems now and in the future by clear monitoring and oversight. The deal had not been reviewed by the General Counsel and the Capital Planning Committee (CPC); and key processes were not in place at that time. A transparent discussion of such a proposed arrangement would be required in today's organizational and procedural environment, and the CPC would not recommend a multi-million deal such as this without full engagement of legal counsel and complete understanding of its implications.

As part of Debt Management Policy, the administration now monitored restrictive covenants in all debt issued by the University, its auxiliaries, and its affiliates including Foundations. A comprehensive report on debt including covenant status was

reported at each meeting of the Executive Committee.

B. Prudential Demutualization - Finding #2: Dr. Moore stated that the existing policy required employees to follow the practices recommended by the auditor; however, employees along the chain of command had not complied with procedures.

Proceedings were underway for key personnel appointments in Human Resources including a Vice President. A national search was nearing completion under the leadership of Chancellor Tom Hallman.

In closing, management was using this finding as a reminder of the importance of compliance with all policies and established procedures.

C. Davis-Bacon Act Compliance - Finding #3: Dr. Moore reported that the finding involved noncompliance as required for federal funding involving construction of the Thomas Cooper Library Special Collections Wing. Currently, the administration had ordered collection of the required documentation to support compliance. In addition, University procedures had been revised to include initial notification of compliance requirements and routine follow-up to ensure compliance henceforth.

D. Buy-America Act Compliance - Finding #4: Dr. Moore stated that this finding involved the North Inlet Winyah Bay Outdoor Classroom Construction. The administration had since ordered the collection of the required documentation to support compliance and revised procedures to include initial notification of compliance requirements and routine follow-up to ensure compliance henceforth.

Chairman Burroughs called for a motion to approve the reports as distributed in the meeting materials. Mr. Whittle so moved. Mr. Allen seconded the motion. The vote was taken and the motion carried.

Chairman Burroughs reported that, in the future, this committee and the administration would work closely to develop timelines for receiving drafts of University financial statements and footnotes so members would have adequate time to review the contents and to ask questions prior to the deadline for forwarding the documents to the full Board for approval as well as the State Comptroller General's Office.

Mr. McCoy said, for clarification, that the audit report was part of the statewide consolidated financial statements. Therefore, the external auditors had until October 15th to submit the report to the State Controller General's Office to include in their statements. Thus, there was a small window of opportunity for auditors to review documents with this committee.

Secretary Stepp stated that Chairman Burroughs had asked him to draft dates for quarterly meetings in 2011 and Oct 7th was one of the dates. Chairman Burroughs recommended that the committee include Executive Sessions in the quarterly meetings so members would have an opportunity to speak individually with the President, CFO, Internal Auditor and finally the external auditors in dealing with audit issues in the future.

The General Counsel encouraged the committee to be sure the items discussed in Executive Sessions met the FOIA requirements.

II. Presentation of Financial Analysis of Financial Statement Information:

Dr. Moore gave the following presentation regarding an analysis of Accounting and Control, Debt Management and Capital Spending, and Financial Integrity and Liability of the University system.

A. Accounting and Control: Recently, the administration reported preliminary results of the campus system study to the Strategic Planning Committee. The study team aided by Huron Consulting had identified instances of significant cost saving opportunities and ways to become more effective in all the areas they were asked to examine - procurement, facilities, human resources, and so forth.

He explained that the "business cases" examined by Huron had revealed that the operating sector largely focused on transactional issues. "We have not maintained the infrastructure employees needed to do their jobs efficiently. What the administration needs going forward is a long-term plan to recognize efficiencies and improvements." It was anticipated that a Board Retreat would be scheduled in February to review these findings and various long-term systematic improvements.

B. Debt Management and Capital Planning: Dr. Moore stated that the Barclays' report indicating that the University's Aa2 rating appeared to be robust would be presented to the full Board next Monday.

The Athletics' debt was currently at the maximum amount. The Director of Athletics and his staff were well aware of this and the debt structure in Athletics was carefully managed.

C. Financial Integrity and Viability: Recently, the administration met with the economist and staff analyst from the Senate Finance Committee, along with our own regional economist Mr. Doug Woodward. The University System would likely see another major cut in state recurring funds going into FY 2012. Estimates totaled approximately \$25 million for the system; \$20 million for Columbia and the School of Medicine.

Dr. Moore stated it would be particularly difficult for the School of Medicine. The administration had contributed \$5 million to resolve their budget deficit and had negotiated a change in covenants so that the technical default was cleared.

He characterized the current budget situation as "a perfect storm that could be brewing" - a state cut of this magnitude was very difficult, but a possible tuition cap imposed by the State Budget and Control Board this year, as well as a likely legislative movement toward a more explicit cut next year, were causes for concern that the President would be addressing with the Legislature and the Governor. The President would enlist the Board's support.

III. Presentation of Draft Audit Committee Charter: Dr. Moore gave an overview of a draft of the Committee's Charter. The Introduction, Audit Requirements, Composition, and Annual Charter Review and Evaluation provisions of the Charter remained the same as previously distributed. He discussed the revisions to the Committee's Scope of Authority which included the Committee's access to staff and faculty; he stated that the Committee

could meet with the President, Chief Financial Officer, Internal Auditor and External Auditor at its discretion.

He expounded upon Risk Management and stated that the Committee would assist the Board in fulfilling its oversight responsibilities with regard to major financial risks to which the University may be exposed including environmental and regulatory risk, default risk, and estimation risk. In addition, was the responsibility to evaluate University financial risk exposure and review the annual report of outstanding and resolved litigation.

The Committee recommended adding reputational risk and a whistleblower policy to the Charter and a clause regarding "transparency." Also, they discussed the possibility of adding a Conflict of Interest policy unless the University's current policy was sufficient.

The recommendation was made to change the name of the committee to "The Audit and Compliance Committee."

Secretary Stepp commented that the Bylaws would have to be amended in order to change the name of the committee. The committee could vote today to make a recommendation to change the name. He indicated that it would take two meetings before the name change would become effective.

Mr. Whittle made a motion to change the name of the committee to the "Audit and Compliance Committee." Mr. Allen seconded the motion. The vote was taken, and the motion carried.

Mr. Whittle asked whether there was already a designated Compliance Officer for the University. He suggested the position could be further defined in the manual which would be developed during the next several months. Or, perhaps, those responsibilities could be added to the Job Description of the Internal Auditor.

President Pastides cautioned the Committee to be careful with the job title because the University would have both a risk manager and a compliance officer who dealt with federal issues at the University.

Mr. McCoy inquired about the Internal Auditor's reporting relationship with the Board. Chairman Burroughs requested that Dr. Moore explore best practices at other institutions and report back to the Committee with his findings.

Chairman Burroughs commended Ms. Leslie Brunelli, Mr. Alton McCoy, and Mr. Ed Walton for all the work they had done on drafting the Committee's Charter.

Since there were no other matters to come before the Fiscal Policy Committee, Chairman Burroughs declared the meeting adjourned at 3:45 p.m.

Respectfully submitted,

Thomas L. Stepp
Secretary