

AGENDA

COMMITTEE ON AUDIT

Meeting: 9:30 a.m., Wednesday, July 19, 2006
Glenn S. Dumke Auditorium

Raymond W. Holdsworth, Chair
Debra S. Farar, Vice Chair
Herbert L. Carter
Carol R. Chandler
George G. Gowgani
William Hauck

Consent Items

Approval of Minutes of Meeting of May 17, 2006

Discussion Items

1. Status Report on Current and Follow-up Internal Audit Assignments, *Information*
2. Progress Report on the Corrective Action Plans for the Audit Findings in the Single Audit Reports for the Year Ended June 30, 2005, *Information*
3. Appointment of an External Auditor for the Financial Audit of the California State University System, *Action*

**MINUTES OF THE MEETING OF THE
COMMITTEE ON AUDIT**

**Trustees of The California State University
Office of the Chancellor
Glenn S. Dumke Conference Center
401 Golden Shore
Long Beach, California**

May 17, 2006

Members Present

Raymond W. Holdsworth, Chair
Herbert L. Carter, Vice Chair
Roberta Achtenberg
Debra S. Farar
Murray L. Galinson, Chair of the Board
George G. Gowgani
William Hauck
Charles B. Reed, Chancellor

Chair Holdsworth called the meeting to order.

Approval of Minutes

The minutes of the meeting of March 15, 2006, were approved as submitted.

Status Report on Current and Follow-up Internal Audit Assignments

Mr. Larry Mandel, university auditor, presented the Status Report on Current and Follow-up Internal Audit Assignments, Agenda Item 1 of the May 16-17, 2006, Board of Trustees agenda.

Mr. Mandel stated that since the Agenda Book mail-out, there had been two updates to the status report regarding follow-up on past/current assignments. Both San José State University and the California Maritime Academy had completed all of their respective outstanding recommendations pertaining to FISMA (financial internal controls review). He commented that the campuses have made great strides in the timely completion of the outstanding recommendations and indicated that their efforts resulted in the most complete status report ever presented to the Trustees.

Chair Holdsworth also commended the presidents and thanked them personally for their attention to and efforts in the timely completion of the outstanding recommendations.

Mr. Mandel discussed Athletics Administration, one of the subject areas selected for the 2006 audit plan. He explained that the initial audit plan, as presented to the Trustees at the January

Audit

2006 Board meeting, included four weeks of fieldwork for each of the Athletics Administration reviews. However, he further explained that during the pilot audit, it was determined that additional areas required review and that the audit plan should be amended to increase the fieldwork to approximately six weeks. Therefore, as per discussion with Chair Holdsworth, instead of the ten originally projected campus reviews of Athletics Administration, it was decided that the number of projected reviews would be reduced to six for the year with perhaps the consideration of performing additional reviews on this subject in 2007.

Chancellor Reed indicated that the California State University (CSU) has engaged Dr. Cedric Dempsey, past president of the National Collegiate Athletic Association (NCAA), to provide consultation on Athletics Administration. He further indicated that Dr. Dempsey would work in conjunction with Mr. Mandel in order to encompass a larger range regarding this subject. Chancellor Reed agreed with the determination that the Athletics reviews be split over two years, especially since this is the first time the CSU has conducted an audit of Athletics.

Chair Holdsworth explained to the Trustees that with the reduction of Athletics Administration reviews from ten to six, consideration would be placed on the Division I schools and our larger Athletics programs. Therefore, six of the seven Division I schools would be included in the audit plan for 2006. Due to the recruitment of the new athletic director and president, California State University, Long Beach (also a Division I school) would be included in the 2007 audit plan.

Chair Holdsworth reported that during the week of March 20, three chief auditors from the University System of Georgia, Cornell University, and the University of Houston conducted a quality assurance review of the Office of the University Auditor. He stated that upon issuance of a report by the quality assurance review team, the recommendations would be reported to the Trustees at a future Committee on Audit meeting.

Chancellor Reed added that this particular review included discussions with, among others, campus presidents, the chair of the Board, chair of the Committee on Audit, and vice chancellors.

Progress Report on the Corrective Action Plans for the Audit Findings of the Consolidated Financial Statements and in the Single Audit Report for the Year Ended June 30, 2005

Mr. Dennis Hordyk, assistant vice chancellor, financial services, presented the item. He reminded the Trustees that although an unqualified opinion was provided by KPMG, the external auditing firm, on the consolidated financial statements, five significant findings were included in the Single Audit Report that were classified as either reportable conditions or material weaknesses. One of these substantial issues was the result of several campuses' inability to complete accurate financial reporting packages on a timely basis and in accordance with Generally Accepted Accounting Principles (GAAP).

Mr. Hordyk provided a progress report regarding the issue pertaining to the financial statement preparation process. He indicated that an action plan had been developed with the campuses that would ensure adequate controls in the financial statement preparation process, specifically targeting improvements in four areas – staffing levels, classifications, compensation, and training:

All campuses that were identified as having staffing problems are either adding accounting staff or reorganizing their current staff, placing more emphasis on GAAP reporting responsibilities. Each campus will have, at a minimum, one knowledgeable professional and a backup person, both with GAAP expertise.

Two new financial analyst classifications have been established to allow for appropriate recruitment and retention of individuals with a higher skill level required due to the complexity of the current accounting environment.

The issue of compensation levels for existing accounting classifications will be reviewed and considered during the upcoming bargaining process.

Two new training positions have been established in the Chancellor's Office, and a campus advisory committee has been created to develop a systemwide training program that would be a year-round process.

Mr. Hordyk reported that corrective action plans pertaining to findings related to federal funds are also in progress as follows:

San Francisco State University is making progress on the completion of the two findings pertaining to effort reporting for payroll costs and sub-recipient monitoring of grants. The campus anticipates completion of its corrective action plans, with validation from the university auditor, by the July 2006 Board meeting.

California State University, San Bernardino is making progress on the completion of the finding pertaining to the reconciliation process that is required for the Direct Loan Program for student financial aid. The campus estimates completion of its corrective action plan by the September 2006 Board meeting.

Humboldt State University has completed its corrective action plan (with validation from the university auditor) pertaining to the reconciliation process that is required for the Direct Loan Program for student financial aid.

Trustee Carter inquired as to whether campuses have the necessary level of resources to handle the staffing requirements of the new emphasis being placed on financial statement audits.

Mr. Hordyk responded affirmatively based on his progress report.

Chair Holdsworth asked whether Mr. Hordyk had any reservations about rectifying the issues regarding the completion of the financial statement process.

Mr. Hordyk stated his belief that a full year would be required to successfully complete this task. He responded that the presidents, vice presidents for administration, and the Chancellor's Office are fully committed to completing this process. He stated that 14 of the campuses are in a massive hiring mode but indicated that recruiting the required amount of accountants statewide will be a difficult process.

Chancellor Reed commented that budget reductions and turnover due to competitors' recruitment of accountants with GAAP experience were the main reasons for the delays in the financial statement preparation process. He acknowledged responsibility for this problem but has since authorized the recruitment and training of the necessary individuals to prevent this from occurring in the future. Chancellor Reed informed the Trustees that Legislative approval has been sought regarding a major change in the process for managing student fee revenue and asked Mr. Hordyk to comment further.

Mr. Hordyk indicated that the change in managing student fee revenue would be a quantum leap in the CSU accounting processes. He explained that all expenses, except payroll, would be paid from a trust fund, instead of through the General Fund with required documentation being forwarded to the State Controller. He further indicated that a committee had been assigned this task and is working diligently, but it would take approximately a year to implement such a huge change. He offered his belief that simplifying this process would result in tremendous efficiencies. He stated that both the Department of Finance and the Governor's Office have agreed to support this change and the request is moving quickly through the Legislature.

Trustee Galinson complimented the tremendous efforts put forth to ensure that future financial statement audits are completed promptly but stressed the importance of continuing this effort.

Chair Holdsworth requested that a progress report on the financial statement preparation process be presented to the Trustees at the July meeting. He also invited comments or observations from the presidents regarding any anticipated problems regarding the efforts pertaining to the timely process for the financial statement preparation at the campuses.

COMMITTEE ON AUDIT

Status Report on Current and Follow-up Internal Audit Assignments

Presentation By

Larry Mandel
University Auditor

Summary

This item includes both a status report on the 2006 audit plan and follow-up on past assignments. For the current year, assignments have been made to conduct reviews of FISMA (financial internal controls), Auxiliary Organizations, Delegations of Authority, Disaster and Emergency Preparedness, Athletics Administration, and Construction. In addition, follow-up on past assignments (FISMA, Auxiliary Organizations, Continuing Education, and Housing and Residential Services) is currently being conducted on approximately 30 prior campus/auxiliary reviews. Attachment A summarizes the reviews in tabular form. An up-to-date Attachment A will be distributed at the Committee meeting.

Status Report on Current and Follow-up Internal Audit Assignments

At the January 2006 meeting of the Committee on Audit, an audit plan calling for the review of the following subject areas was approved: FISMA (financial internal controls), Auxiliary Organizations, Delegations of Authority, Disaster and Emergency Preparedness, Athletics Administration, and Construction.

FISMA

The initial audit plan indicated that approximately 144 staff weeks of activity (17 percent of the plan) would be devoted to auditing financial internal controls on 12 campuses. One audit awaits a campus response prior to finalization, and report writing is being completed on five campuses.

Auxiliary Organizations

The initial audit plan indicated that approximately 257 staff weeks of activity (31 percent of the plan) would be devoted to auditing internal compliance/internal control at 8 campuses/29 auxiliaries. One campus/four auxiliary reports await a campus response prior to finalization, and report writing is currently taking place at three campuses/twelve auxiliaries.

Delegations of Authority

The initial audit plan indicated that approximately 97 staff weeks of activity (12 percent of the plan) would be devoted to a review of ten campuses to ensure proper management of the processes for administration of purchasing and contracting activities, motor vehicle inspections, and real and personal property transactions. One audit awaits a campus response prior to finalization, report writing is being completed at two campuses, and fieldwork is currently taking place at three campuses.

Disaster and Emergency Preparedness

The initial audit plan indicated that approximately 97 staff weeks of activity (12 percent of the plan) would be devoted to a review of ten campuses to ensure proper management of and/or compliance with bond resolutions, Trustee policy, and systemwide directives; contingency and disaster recovery planning; backup communications; building safety and emergency egress including provisions for individuals with disabilities; the extent of plan testing; and relationships with state and federal emergency management agencies. One audit awaits a campus response prior to finalization, report writing is being completed at one campus, and fieldwork is currently taking place at two campuses.

Athletics Administration

The initial audit plan indicated that approximately 97 staff weeks of activity (12 percent of the audit plan) would be devoted to a review of ten campuses to ensure proper administration/review of the general control environment for athletics and control activities undertaken to assure implementation of appropriate institutional systems, policies and procedures for financial oversight, and stewardship of athletics. Report writing is being completed at one campus, while fieldwork is currently taking place at two campuses.

Information Systems

The initial audit plan indicated that approximately 43 staff weeks of activity (5 percent of the plan) would be devoted to review of systemwide projects such as: Disaster Recovery, Common Management Systems (CMS), and Web Security. In addition, support will be provided in the area of financial internal controls for both campus (FISMA) and auxiliary audits. Review and training are ongoing.

Follow-ups

The audit plan indicated that approximately 26 staff weeks of activity (3 percent of the plan) would be devoted to follow-up on prior audit recommendations. The Office of the University Auditor is currently tracking approximately 30 prior audits (FISMA, Auxiliary Organizations, Continuing Education, and Housing and Residential Services) to determine the appropriateness of the corrective action taken for each recommendation and whether additional action is required.

Consultations

The Office of the University Auditor is periodically called upon to provide consultation to the campuses and/or to perform special audit requests made by the Chancellor. Thirty-four staff weeks have been set aside for this purpose, representing approximately 4 percent of the audit plan.

Investigations

The Office of the University Auditor is periodically called upon to provide investigative reviews which are often the result of alleged defalcations or conflicts of interest. In addition, whistleblower investigations are being performed on an ongoing basis, both by referral from the State Auditor, and directly from the chancellor's office. Thirty-six staff weeks have been set aside for this purpose, representing approximately 4 percent of the audit plan.

Construction

The audit plan indicated that approximately five staff weeks of activity (1 percent of the plan) would be devoted to coordination of construction auditing. For the 2005/06 fiscal year, six construction projects are being reviewed by KPMG with coordination from the Office of the University Auditor. Areas under review include construction bid process, change orders, project management services, contractor compliance, liquidated damages, and cost verification of major equipment and construction components. Five staff weeks have been set aside for this purpose, representing approximately 1 percent of the audit plan. Three audits await a response prior to completion, and three audits are in the report writing stage.

Status Report on Current and Follow-Up Internal Audit Assignments
(as of 7/17/2006)

	2006 ASSIGNMENTS					FOLLOW-UP ON PAST/CURRENT ASSIGNMENTS								
	FISMA	Aux Orgs	Deleg of Authority	Disaster and Emerg Prep	Athletics Admin	FISMA		Auxiliary Organizations			Continuing Education		Housing & Residential Svcs	
						*Recs	**Mo.	•No.	*Recs	**Mo.	*Recs	**Mo.	*Recs	**Mo.
BAK			FW			13/13	-	3	22/22	-				
CHI	RW							3	32/32	-	8/9	7		
CI						23/23	-	2	26/26	-				
DH						5/5	-	3	36/36	-				
EB	RW							4	65/65	-				
FRE				FW		0/7	2	6	39/47	8				
FUL		AI			FW	7/7	-	4			5/5	-		
HUM						10/10	-	3	25/25	-				
LB			RW			12/13	3	3	27/27	-	3/5	5	10/10	-
LA	RW							4	42/42	-	2/2	-		
MA						7/7	-	2	0/14	2	0/12	5		
MB						25/25	-	2	0/17	3				
NOR	AI	RW						5					9/9	-
POM				FW		11/11	-	3	24/24	-	5/7	5	10/11	7
SAC					RW	13/13	-	5	33/36	6				
SB		RW				8/9	4	3						
SD				AI		7/7	-	4	21/21	-			10/10	-
SF		RW	FW			6/6	-	4					7/7	-
SJ			AI		FW	16/16	-	4	42/42	-				
SLO	RW							2	29/29	-			4/4	-
SM	RW							3	34/34	-	3/5	4		
SON				RW		6/6	-	4	21/21	-			10/10	-
STA			RW			15/16	9	4	27/27	-				
CO			FW			4/4	-	2	11/11	-				
SYS													0/8	2

FW = Field Work In Progress
RW = Report Writing in Progress
AI = Audit Incomplete (awaiting formal exit conference and/or campus response)
AC = Audit Complete

* The number of recommendations satisfactorily addressed followed by the number of recommendations in the original report. A "0" in a column is used as a place holder until such time as documentation is provided to the OUA evidencing that a recommendation has been satisfactorily addressed; significant progress may have been made prior to that time.
Numbers/letters in red are updates since the agenda mailout.
**The number of months recommendations have been outstanding (since the formal campus exit conference).
• The number of auxiliary organizations reviewed.

COMMITTEE ON AUDIT

Progress Report on the Corrective Action Plans for the Audit Findings in the Single Audit Reports for the Year Ended June 30, 2005

Presentation By

Dennis Hordyk
Assistant Vice Chancellor
Financial Services

Summary

Corrective action for Audit Finding 05-01 Financial Statement Preparation Process Reportable Condition is still in progress. The Chancellor's Office has worked with campuses to develop guidelines to remedy weaknesses identified from the audit through improvements in staffing, classification, compensation, and training. Various campuses are in the process of implementing corrective steps based on the guidelines. Further information on the status of preparation for the year-end closing of the financial books will be made at the July meeting.

Further information on the corrective actions for the following audit findings will be presented at the meeting:

- 05-02 San Francisco State University Research and Development Cluster Grants Effort Reporting for Payroll Costs
- 05-03 San Francisco State University Research and Development Grants Subrecipient Monitoring
- 05-04 California State University, San Bernardino Direct Loan Program Reconciliations
- 05-05 Humboldt State University Direct Loan Program Reconciliations

REVISED

COMMITTEE ON AUDIT

Appointment of an External Auditor for the Financial Audit of the CSU System

Presentation By

Richard P. West
Executive Vice Chancellor and
Chief Financial Officer

Dennis Hordyk
Assistant Vice Chancellor
Financial Services

Summary

The CSU issued a Request for Proposal (RFP) on March 14, 2006 for the purpose of soliciting proposals from qualified independent public accounting firms with the intent of establishing a CSU master service contract for the performance of a variety of financial and other audits. The recommendation of the evaluation team, based upon the analysis described below, is that KPMG has proposed a contract with the best value to the California State University and should be awarded the contract.

Proposal Solicitation

The RFP was issued on March 14, 2006 with public advertising occurring in the California State Contract Register. The RFP and all attending documents and announcements were posted to the CSU Planetbids web site. In an effort to encourage as many CPA firms as possible to submit a proposal, when the RFP was released, CSU took the additional step of contacting by phone and email several firms to advise them of the solicitation. Before the bid process was initiated meetings were held with many audit firms to discuss the scope and complexity of the CSU audit. PriceWaterhouseCoopers, Ernst and Young, Moss Adams and Macias Gini each had meetings with CSU staff to better understand the CSU environment and expectations. Of these firms, Moss Adams and PriceWaterhouseCoopers formally declined to submit a bid at this time due to their inability to devote enough higher education audit resources to perform an audit of this size. Over the course of the RFP 23 firms downloaded the RFP document. At the close of the bidding we received proposals from two firms, KPMG and Macias Gini.

Proposal Evaluation

The evaluation was based on the best value approach. The responses were evaluated based on 1) project management team qualifications and experience, 2) proposer work plan / methodology, 3) technical expertise of firm, 4) organizational resources, and 5) cost. Both bidders were sent clarification questions; and both bidders replied with answers. In addition, Macias Gini & Company (Macias) was invited to a fact-finding interview to further clarify its response. The University's evaluation team was made up of campus and Chancellor's Office staff, including the University Auditor. Every member of the evaluation team's comments is reflected in the final weighting of each category outlined in the RFP. Although the Macias Gini proposal was less costly, the overall evaluation of the two bids reflected the unanimous view of the team that KPMG provided the best value or highest quality per dollar.

KPMG demonstrated it had a highly qualified team with extensive knowledge of the higher education environment and a clear understanding of the size and scope of the audit. KPMG proposed a comprehensive methodology that exhibited a thorough understanding of the technical and coordination effort necessary to complete the audit and sufficient resources to ensure capability and stability.

The Macias proposal was scored lower than the KPMG proposal in all four of the areas described above. The Macias firm is a quality public accounting firm, although their proposal generally did not demonstrate sufficient capacity to do an audit of the size of the CSU. The company did not demonstrate convincingly how it would gather knowledgeable and skilled resources to coordinate and complete an audit at 24 locations, with 87 separate auxiliaries, in the timeframe required. A subcontractor provided over 60% of the total available hours in the Macias proposal, even though the subcontractor's role was described as being available if needed. Additionally, that subcontractor indicated it had few resources with higher education experience in the Los Angeles area, and lacked a strong presence in higher education at the national level.

While the Macias proposal had a lower cost amount, that amount was predicated upon an assumption that there would not be substantive changes in audit standards over the five-year period of the contract. Audit standard changes are quite normal and should be expected, even though we cannot predict those changes today. Macias indicated changes might result in the need to increase the audit costs charged to the CSU. The KPMG proposal indicated it was willing to absorb any additional costs associated with new audit standards.

REVISED

Recommended Action

Based upon the proposal evaluation, the contract should be awarded to KPMG. The following resolution is presented for approval:

RESOLVED, By the Board of Trustees of the California State University to enter into a master service contract with KPMG LLP for the performance of a variety of audit tasks for the five fiscal years ending June 30, 2007, 2008, 2009, 2010, and 2011; with optional one-year extensions for up to three additional years.