1979

Board of Trustees Audit Committee February 16, 1979

University Of Maine System

UNIVERSITY OF MAINE
BOARD OF TRUSTEES

February 16, 1979
Portland, Maine

AUDIT COMMITTEE

PRESENT: Chairman Artemus Weatherbee, Patricia DiMatteo, Joseph Hakanson, Susan Kominsky. Staff: William Sullivan and Lawrence Stanchfield. Arthur Anderson & Company representatives: James Russell, William Daley, David Murray.

Chairman Weatherbee convened the meeting and representatives from Arthur Anderson & Company formally presented the auditors' report of the 1978 Examination. Mr. James Russell, Mr. William Daley and Mr. David Murray participated in the presentation. In his introductory remarks, Mr. Russell indicated that the presentation would cover the mechanics of the audit process, a review of the major considerations of the 1978 Examination and the contents of the management letter. Committee members were invited to raise any questions they might have throughout the presentation.

Scope of the Audit. Mr. Russell briefed the Committee on the audit process which focussed on methods and controls as well as substantive audit procedures. He reviewed the role of the University's Internal Audit Department and took note of the audit work performed at the campus level with respect to student accounts, fund balances and physical plant inventory. Mr. Russell also outlined procedures employed which include transaction flow review of payroll and accounts payable, tests of the billing cycle, tuition and fee reviews, indirect cost recovery and other financial activity.

Major Audit Considerations. Mr. Daley reported that the major item addressed was the deficit of approximately one-half million dollars in the residence and dining operations at Orono, and that the auditors were concerned primarily because of the insufficient reaction at the campus where the loss was not effectively analyzed nor corrective action taken when the loss first became apparent. He indicated that the entire deficit is attributed to increased expenditures since campus revenues were realized in excess of budget. Mr. Sullivan briefed the Committee on campus reaction to the deficit. He reported that he wrote to President Neville when the deficit was detected in July and received his response July 31. The President said he expected that the deficit would be adjusted downward a) after accounting for increased inventory and b) through repayment of funds borrowed from the residence/dining operation for alterations to the Health Center. He acknowledged that expenditures had exceeded budget in several areas:

a) maintenance and equipment - due primarily to early completion of projects which were expected to be charged in 1979;
b) salaries, wages and benefits were underestimated;
c) student wages - overexpenditure reflects increase in minimum wage and employment of more students than anticipated.

President Neville also noted that campus procedures had been revised to prevent a repetition of the situation.

At Mr. Sullivan's request, Mr. Stanchfield, Director of Internal Audit, commented on the campus response:

a) maintenance projects - all projects had been completed prior to December, 1977, which was early enough for the campus to have taken action. In response to questions from the Committee concerning central office approval of charges during this period, Mr. Stanchfield reported that all charges had not been submitted by the campus for approval. He indicated that failure to submit charges for approval was not routine or widespread;

b) campus inventory had decreased rather than increased;

c) repayment of the Health Center loan would not serve to reduce the deficit since it would have no effect on the operating budget.

Mr. Weatherbee inquired about the impact of student wages being raised to minimum wage; he recalled that the Finance Committee had concurred with this action with the understanding that no additional costs were involved. Mr. Sullivan replied that many students were already receiving more than the new minimum wage and campuses were to absorb the extra costs through a reduction of hours. He pointed out that the cut-back was not executed at Orono and, even so, an increase for all eligible student employees to the minimum was probably not sufficient to account for the size of the deficit in the student wage account at UMO.

There was discussion of the implications the deficit will have for the campus budget in the coming year. Mr. Sullivan noted that the deficit would in effect eliminate any reserve in the residence/dining operation and debt service would have to be paid from operating funds at the beginning of the year. He noted that a half-million dollar reserve would have been an important element in negotiations for the long-term financing which must be arranged for the student apartment-housing project which is underway. In response to questions from the Committee about earlier detection of problems, Mr. Sullivan explained that the problem is basically one of procedure and controls rather than any question of impropriety and the staff is endeavoring to identify the inadequacies in the control system and will take preventive measures.

Mr. Sullivan briefed the Committee on one other element which will have a bearing on measures needed to recover the deficit. He reported that last Fall the campus proposed to transfer $198,000, which was recorded as an 'administrative charge,' from the current year's residence/dining budget account to the President's Contingency Fund. Mr. Sullivan said his office questioned the proposed transfer and since it appeared to be a major new charge, the request for transfer was denied. He noted that an overhead rate of 10% is authorized for Orono and that this is a legitimate charge which covers bookkeeping costs. The so-called administrative charge represented an additional 2% which the campus contended was needed to cover expenses not charged elsewhere. Mr. Sullivan said the staff subsequently determined that this 2% administrative charge has been assessed by the Orono administration for several years, with the receipts generated being transferred to the President's Contingency Account. It was further determined that an administrative charge of $197,000 in the 1978 budget year contributed to the half-million dollar deficit in the 1978 residence/dining operation. Mr. Sullivan pointed out that the irregular aspects of the situation are the unauthorized assessment of the 2% charge and the practice of adding to the President's Contingency Fund from operating accounts. He emphasized that there is no question of any campus funds being appropriated for personal gain; at issue is the unauthorized transfer of funds from one legitimate account to another legitimate account. He took note of some of the transfers which include: overhead charges assessed against the residence/dining operation, bookstore, and other accounts and transferred to the President's Contingency Fund; some incentive budgeting funds transferred to the President's Contingency Fund; monies from the President's Contingency Fund transferred to the Alfond Arena account. Mr. Sullivan reported that in view of the deficit, the Chancellor will direct the campus to reverse the administrative charge to restore the $197,000 assessed on the 1970 residence/dining budget, and to reestablish a reserve for debt service with these funds.

Mr. Russell noted that the deficit situation demonstrated the need for policies to govern administrative charges and the use of discretionary funds. He also suggested that the rewards and sanctions of the incentive budgeting program should extend to the auxiliary enterprise accounts as well as E & G bugets. During discussion of incentive budgeting, Mr. Sullivan elaborated on the rationale for the program and responded to questions of interest from the Committee. He said that the campuses operate on tight budgets which he believes are well managed. He indicated that the budget base tends to grow more rapidly under a use-or-lose philosophy and the incentive program encourages campus administrators to spend less by making any savings available for legitimate campus discretionary purposes. He reported that 20% of any such savings is assigned to a maintenance reserve and the remainder must be identified and budgeted. On the other hand, if budgets are overspent, any deficits must be made up in subsequent years. He said that experience with the program has identified areas where policy guidelines would be desirable and that the staff would report back with specific recommendations. After further discussion, Mr. Weatherbee summarized the consensus of the Committee that the staff should:

1. develop recommendations for policies on a) administrative charges, b) use of discretionary funds and c) incentive budgeting;

2. report on the use made of discretionary/contingency funds over time and at all campuses;

3. report on the resolution of the UMO residence/dining budget deficit.

There was discussion of sponsored programs. With respect to accounts receivable related to grants, Mr. Daley suggested that more use of the accounting system could improve billing of grant costs, which are expended in advance. Mr. Weatherbee expressed concern for the lack of information on the substance of grant proposals. Mr. Sullivan suggested that a research report could be compiled to provide information about the kinds of research being undertaken and an indication of future directions for this area. Mr. Murray added that it would also be helpful to have information about campus policies on the grant review and screening process. Mrs. Kominsky noted that some areas of interest provide more opportunities than others for grant development or consultation which enables faculty with certain specialties to attract substantial additional compensation, and she expressed concern for these inequities. The Committee requested that a report be prepared for submission to the Board through the Educational Policy Committee, which would include the status of ongoing research, outside employment policy and any available information concerning extra compensation.

Mr. Daley summarized the major results of the audit and there was discussion of collectibility reserves for student accounts and of deficits which continue in some funds. It was pointed out that deficits occur for various reasons which include timing of funding authorizations, start up costs, deferral of expense, among others. Mr. Russell indicated that charging deficits to incentive budgeting savings is an effective way to resolve these problems and he took note of the auditors' recommendations for improved management control. Questions were raised about student loan programs and financial aid. Mr. Sullivan acknowledged that loan collections and federal billing could be even further improved and he said the staff was now managing this area more effectively. He reported that major computing systems have been established for accounting and payroll functions and that these are working well. The next major system under consideration would be one which administers financial aid, and a committee is reviewing new systems for this area.

After a brief recess for lunch, Mr. Sullivan and Mr. Stanchfield excused themselves to provide an opportunity for the Committee to discuss the management letter with the auditors privately. In the interest of time, Mr. Russell indicated he would not go through the document point by point and he suggested that Committee members raise any questions they might have. Questions from the Committee focussed on various issues; major discussion points are set forth below in summary form:

1. Staff relationships and performance. In response to questions, the auditors indicated that there have been no problems from the combining of the treasurer and the administrative vice chancellor positions. They reported that the staff is cooperative and does not attempt to influence the auditors. The Committee was assured that the Vice Chancellor is a capable administrator and that there is a high level of expertise among the line staff responsible for accounting, budget and internal audit functions. Mr. Russell said there is adequate competence among staff responsible for financial matters at the small campuses although competency in this area is not significant to cash management. He pointed out that the internal auditor visits the campuses regularly and that this practice continues to be productive and mutually beneficial.

2. Implementation of auditor recommendations. Mr. Russell reported that the Vice Chancellor is making good progress in this area. He noted that the University's educational objectives are

rightfully the primary concern although these can't be addressed in isolation from financial management. He said he believed that appropriate progress is being made in handling the financial affairs and pointed out that it will be important to further improve the control mechanisms in order to identify problems before any become critical. The necessary systems are already in place to support the long range financial objectives.

3. Implementation of Board Policies. Committee members were interested in the implementation of Board policies and concerned about the extent to which management is able to translate the Board's intent as these policies are carried out at the various levels in the system. Mr. Russell indicated that any serious deviations should be detected as the auditors review the minutes of the Board's meetings and track into the accounting records to check on the follow-up. He pointed out that for the long range, development of a control strategy would provide a framework for evaluating policies and procedures. He suggested that the Committee may want to request a quarterly report on the status of the largest accounts within the system, as a monitoring mechanism.

After discussion of general interest items, there was consensus among the Committee members that the auditors recommendations should be implemented as soon as possible. After the auditors departed, Mr. Stanchfield returned briefly at the request of Chairman Weatherbee for discussion of the internal audit function. He reported that he had no problems with the auditors or Chancellor's Office staff and that he was reasonably pleased with the performance of his own staff, which is relatively new. There was discussion of his reporting arrangement and he was informed that he was free to report direct to the Committee should the need arise. In response to questions, he reported that his work program is developed in consultation with the external auditors and he outlined the general program for the coming year. Committee members inquired about outstanding recommendations from the auditors and he indicated that the Vice Chancellor has made a good effort since his arrival and he pointed out that some recommendations will take time and money. It was agreed that he should meet with the Committee periodically. For the May meeting, the Committee requested that he plan to report on the status of any recommendations from the auditors since 1971 which are still outstanding. Mr. Stanchfield departed and Mr. Sullivan returned for discussion of the management of the University's investment portfolio. Mr. Hakanson distributed an analysis he had compiled of the performance of Putnam Capital Companies, the portfolio manager compared with other investment managers. He briefed the Committee on the major conclusions. He pointed out that Putnam had exceeded the requirement for producing income but other objectives had not been met. He suggested that the Committee might want to examine the investment objectives to determine whether these should be changed. In response to questions from the Committee about his position, he said that the managers should be expected to produce dividends at a rate which exceeds inflation. In times when the market is undervalued, he suggested it would be best to move into the equity market and he preferred not to use long term bonds. There was general discussion of the risks of the equity market and of the need for further review. Mr. Hakanson recommended that the Committee review the objectives, which he called a basically good statement, and examine other studies of market performance in preparation for further discussion at some future time. Mr. John McMurtrie, Putnam representative, and staff member, Richard Harshman, joined the Committee. Mr. McMurtrie presented a brief perspective of Putnam's performance. Further discussion by the entire Committee was foreclosed due to the lateness of the hour. Mr. McMurtrie remained for a brief informal discussion with Mr. Hakanson and Mr. Weatherbee. With the understanding that the Committee would carefully review the issue in some depth over the next few months, the meeting was adjourned.

JoAnne R. Magill

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Clerk of the Board