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To the Audit, Compliance and Management Review Committee of
The University of Texas System
Austin, Texas

Dear Audit, Compliance and Management Review Committee Members:

In planning and performing our audit of the financial statements of The University of Texas System (the "System) for the year ended August 31, 2005 (on which we have issued our report dated December 20, 2005), we developed the following recommendations concerning certain matters related to internal control and certain observations and recommendations on other accounting, administrative, and operating matters relating to the System. Our comments are presented in the attached Exhibit. A description of the responsibility of management for establishing and maintaining internal controls, and of the objectives of and inherent limitations in such controls, is set forth in the attached Appendix, and should be read in conjunction with this report.

This report is intended solely for the information and use of the Audit, Compliance and Management Review Committee, management and others within the organization, and the Texas State Auditor's Office and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing any of the suggestions.

Yours truly,

Deloitte + Touche LLP

EXHIBIT

FEDERAL AND NONFEDERAL RESEARCH GRANTS

Observation

During fiscal 2004, management at UT Medical Branch at Galveston (UTMB) discovered certain accounting and compliance issues involving Federal and non-Federal grants. Prior to the implementation of PeopleSoft, which is the software program used to track and bill grants, there were inconsistencies in the accounting treatment for these grants. Upon the conversion to PeopleSoft, the grant tracking and accounting did not improve. In July of 2005, an upgrade to the PeopleSoft software was implemented, and as part of the preparation for that upgrade, a detailed list of issues and enhancement requests was compiled. Management has indicated that the issues deemed critical to the integrity of data and processes were resolved with the upgrade; however, they continue to work on implementing the remaining requests, many of which pertain to grants administration. Additionally, UTMB programmers made modifications to tailor the module to its internal reporting needs, and upon doing so, were not aware of how these modifications were impacting other modules (including general ledger, commitment control, and project resources) that interface with the grants module.

Subsequent to year end, UTMB management "self reported" to the granting agency, describing the nature of the issues identified to date.

Recommendation

We recommend that the newly established internal project team continue to aggressively 1) implement the process and internal control improvements around grant accounting and correct the related accounting software module interfaces, 2) work with the Executive Director of Compliance to resolve and report any compliance issues to the Federal government as accurately and timely as possible, and 3) reconcile and ensure that all outstanding billed and unbilled recorded receivables are appropriate and accurate.

Management Response

Significant improvements continue to be made in our business processes related to grants administration. Resources have been increased to proactively address remaining compliance, quality, systems and accounting issues. Communications are in process to apprise various Federal sponsors of our status and progress in these areas. We have made every effort to ensure that current receivables are being billed appropriately and accurately. We are reviewing recent historical billing activity and will work with our sponsors to determine whether any corrective actions are required. UTMB's executive management is committed to ensuring that our grants administration functions meet or exceed sponsors' expectations.

FINANCIAL REPORTING

Observation

The audit of the consolidated financial statements of the System highlighted the successful financial reporting process that the System Administration Office of the Controller has implemented. That financial reporting process included gathering data from 15 institutions, UTIMCO, and System Administration; reviewing that information for reasonableness; consolidating that data; and drafting consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. A successful financial statement drafting session was held near year end, and preliminary financials were provided to the auditors by early November, with final information provided before the end of November. The System is to be commended for producing the consolidated financial statements for its first-ever audit on a timely basis.

The physical process of combining the data from the various institutions is accomplished through use of a complex spreadsheet. Though this process has been effective, spreadsheets are subject to inadvertent errors because they are easily changed. Additionally, any changes do not leave an audit trail. An organization as complex as the System would benefit from a financial reporting system that could more efficiently accumulate data directly from the general ledgers of the institutions and consolidate the data within that reporting system. Additionally, the implementation of an integrated consolidation package would allow the System to generate monthly or quarterly financial statements that could be used by management to track financial results on a System-wide basis.

Recommendation

Consider alternatives for consolidation of financial information from the institutions. Alternatives include, but are not limited to, an off-the-shelf consolidation package that would simply replace the existing consolidation spreadsheet or a financial reporting system that might include not only the ability to perform the consolidation within the system, but also provide new general ledgers and a chart of accounts that are common among the institutions.

Management Response

System has engaged the services of a consultant to evaluate and consider opportunities for institutions to collaborate in what might be a more effective and efficient mechanism to provide enterprise systems. This evaluation includes the study of a shared services model with UT Dallas, UT Arlington, UT Tyler, UT System Administration and possibly other UT System institutions. Due to the complexity of such an undertaking, it is anticipated that further investigation of integrated financials will be ongoing with the Executive Vice Chancellor for Business Affairs, campus business officers and auditors, and the Finance and Planning Committee of the Board of Regents. This will require extensive gathering of information about time, costs, impact on the campuses, and a myriad of other variables.

CENTRALIZED POLICIES

Observation

Certain accounting and financial reporting policies are not standardized for the System. Examples of areas and accounts that do not have standardized policies include: the allowance for doubtful accounts, capital asset collections, cut-off for accounts payable and the current/non-current classification of certain assets and liabilities.

While we understand that the operations of each institution are unique and that the System Administration Controller's Office may not have complete authority to dictate accounting policies and procedures for all business offices, the System as a whole would benefit by taking advantage of more centralized policies and procedures. The consolidated financial report would be more meaningful and consistent, and individuals from the institutions could utilize their counterparts from other institutions for support and guidance more effectively if all institutions were following centralized accounting policies and procedures.

Recommendation

Consider adopting centralized policies and procedures for all accounting and financial reporting matters. The existing Committee on Financial Reporting and Procedures ("COFRAP") structure could be utilized to determine where existing practices are divergent, as well as to serve as the framework for disseminating new or revised policies and procedures.

Management Response

The Office of the Controller has already begun centralizing policies for ease of access and to facilitate consistent treatment for accounting and financial reporting matters. Prior to the completion of the audit, Business Procedures Memorandum 71 was established as the centralized location for such policies. Currently policies exist for: 1) Preparing the Annual Financial Report; 2.) Accounting and Financial Reporting for Nonexchange Transactions; 3.) Capital Leases vs. Operating Leases for Lessees; 4.) Construction in Progress; 5.) Capitalization of Interest; and 6.) Determining Value of Trust Minerals.

Our process has been to address the most difficult issues or those treated with the least amount of consistency first. The policy is drafted and vetted throughout the institutions for comments and suggestions before it becomes part of the BPM.

We agree with the recommendation and will continue to add policies as needed on a priority basis and to strive to keep all policies published within this BPM current.

VALUATION METHODOLOGY FOR FAIR VALUE OF PUF LANDS

Observation

The System holds certain real estate, known as the Permanent University Fund ("PUF") lands, as an investment. The PUF lands are carried at estimated fair value, consistent with other investments held by the System. Because this investment does not have a readily determinable fair value, the estimate of the fair value of PUF lands is calculated by the System using the current (rather than historical or expected future) prices for hydrocarbons, based on guidance from the accounting standard for disclosures of oil and gas reserves. Using current prices for oil and gas could lead to volatility from year to year and, although acceptable, may not be a preferable method of calculating fair value. An historical average or expected future pricing may provide a more accurate and less volatile method of estimating fair value for this investment.

Recommendation

Consider revising the pricing of hydrocarbons used to estimate the fair value of PUF lands. Because the estimation methodology used by the System has been adopted by a number of agencies of the state of Texas, any revision to the methodology should be done in conjunction with the state land office, the Comptroller's office and other interested parties.

Management Response

System Administration sought input from the General Land Office regarding this recommendation as suggested. They are disinclined to change the methodology for these reasons:

- Using expected futures pricing is not desirable as exchange traded volumes far exceed physical sales and are highly volatile and speculative.
- Historical average pricing presents problems because there is no statute of limitations, so adjustments to historical volumes are quite common. Also, historical prices in general would lead to an undervaluation in time of increasing prices, and an overvaluation is time of declining prices.
- Continuing to use the current mythology would be consistent with what was done in the past. Additionally, the methodology is adequately disclosed in the notes to the financial statements.
- Other factors in the calculation such as the inability to determine proven undeveloped and proven non-producing/behind pipe reserves further underscore that the calculated value is just an estimate, so the price used in not the only consideration one should consider when determining if the value is "accurate."
- Hiring a valuation specialist to determine a more "accurate" value would be prohibitively expensive.

System Administration sees merit in GLO's reasons not to change the calculation. If the increases (or decreases) in the calculated value of PUF lands were not appropriate fiscal reporting, the calculation would be modified. Since the current methodology is not inappropriate and it is adequately disclosed, we agree with GLO and we too are disinclined to modify the calculation.

IBNR ESTIMATE METHODOLOGY

Observation

Actuarial valuations to estimate the incurred but not reported (IBNR) liabilities for various risks of loss are performed by specialists outside the System. The outside actuaries do not currently use individual case reserves for workers' compensation. They also use industry data rather than rely on System loss experience in the ROCIP program. Calculations of the IBNR liability are estimates of the future claim runoffs and a margin for conservatism is normally appropriate. IBNR in the employee health program is slightly outside the standard margin of 5-15%. Certain assumptions and/or data used in the actuarial valuations may be enhanced by using additional data.

Recommendation

Reevaluate the factors and assumptions used to calculate the IBNR liability estimates with additional System historical information. Consider whether more accurate estimates may result from adjustment of the data.

Management Response

Although there is no indication that the current estimates and assumptions are inaccurate, additional data normally will enhance actuarial valuations. The actual performance of all of these self-funded/self-administered programs demonstrate they are adequately funded and well managed.

For the workers' compensation studies, we have used only paid claim data because there is a limited history of individual case reserves with which to work. Although we do reserve individual cases, we have only done so for a few years and have not had the appropriate level of confidence in these individual reserves to use as a factor. As we move forward, we now have some data to begin to incorporate available information on case incurred claims in the analysis in addition to the information we have on paid claims.

For the ROCIP program, there are an insufficient number of claims to use in determining development patterns. In addition, the program covers a variety of independent contractors; has four phases, each with its own "personality"; and there has been a change in claim administration. All of these factors make the ROCIP historical data less useful for development purposes.

For employee health, the margin was actually about 19% of the IBNR liability estimate as of August 31, 2005. This conservative approach is appropriate given historical experience with this program and rising health care costs.

The System and outside actuaries will continue to utilize best practices and all available reliable historical data as appropriate in IBNR estimating methodology.

ACCOUNTS PAYABLE PROCESS

Observation

The cutoff for payables at year end is accomplished by a variety of methods across the System. The two most common methods are a "lag analysis" and a "rollback" process. The "lag analysis" captures the historical trends of the time it takes the institution to process vendor invoices and then estimates the amounts to be recorded as accounts payable at year end. The "rollback" process typically utilizes invoice dates included in the ledger system to determine which payments made after year end should be recorded as accounts payable at August 31. The lag analysis produces reasonable results but is subject to error when patterns of payment change. Additionally, institutions that use this methodology typically exclude certain types of payments (e.g., for construction in process), which must be analyzed separately. The rollback process also produces reasonable results but is subject to error if the invoice dates do not mirror the actual service or delivery dates of the services provided or goods received, respectively. The decentralized nature of the institutions, in which departments have approval authority, can adversely impact the timeliness of payment patterns and the accuracy of the service/delivery dates. Adjustments at various component institutions were identified during the year end audit related to the cutoff of accounts payable.

Recommendation

Evaluate the existing methodologies in place to record accounts payable at year end. For those performing a lag analysis, evaluate the accuracy of the estimate produced against the actual accounts payable at year end; if significant differences are noted, revise the lag analysis to capture additional data to refine the estimate. For those performing a rollback process, assess the accuracy of the service/delivery dates to ensure that they accurately reflect date of service or delivery, and not simply the invoice date. Consider involving the operating departments in these analyses in order to ensure that any changes are feasible for all affected departments.

Management Response

We will evaluate the existing methodologies to record accounts payable at year end in consultation with the institutions. Where necessary, the lag analysis and rollback methodologies will be adjusted to capture information to more accurately reflect accounts payable at year end.

INFORMATION TECHNOLOGY COMMENTS

CHANGE MANAGEMENT CONTROLS

Observation

Inconsistent change management procedures in design and operation caused some institutions' departments to have control deficiencies in their process. Although the individual situation at each institution varies, some of the deficiencies noted that could be attributed to inconsistent procedures were:

- Inconsistencies on tracking changes or not tracking changes at all,
- Maintaining adequate support of approvals for the change request, approval of testing results, and final approval to move change into production, and
- Maintaining testing support

Failure to implement and adhere to change management procedures could result in significant problems such as network and system failure, business downtime, and potential coding errors introduced that might impact the integrity of the financial statements.

Recommendation

The institutions' change management policies and procedures should be enhanced to address the testing requirements, documentation retention, and approval requirements for each change category/risk level. The use of a centralized IT change management system should be enforced for all departments within the institutions and change categories according to the adopted standard or procedure.

Management Response

System management agrees that having risk-based change management policies and procedures to address the testing requirements, documentation retention, and approval requirements that meets the needs of each institution is prudent. System management will convene the Chief Information Officers of the institutions to determine how to do this risk analysis and what are appropriate mitigation strategies including the use of a centralized IT change management system for the departments within the institutions.

CENTRALIZATION OF POLICIES, STANDARDS AND PROCEDURES

Observation

Although the institutions have centrally developed high level security policies, standards and procedures for all departments on their campuses, each individual department creates their own specific standards and operational procedures. As observed across the institutions, inconsistent standards and procedures are being used for change management and information system security.

When policies, standards, and procedures are not managed with a campus-wide perspective, inconsistencies that result in loss or damage to the integrity, confidentiality, and availability of information and systems are more likely to occur.

Recommendation

Each institution should consider centrally defining the minimum expectations that each of its departments should meet and operate under by creating detailed policies, standards, and procedures that need to be followed across the institution for change management and information system security.

Management Response

System management concurs that having detailed policies, standards, and procedures to be followed across each institution for change management and information security would reduce the potential for loss. System management will convene the Chief Information Officers of the institutions to discuss change management information security issues and develop an action plan for each institution.

INFORMATION SYSTEMS SECURITY

Observation

Inconsistent information systems policies and standards caused some departments to have control deficiencies in their systems. Although the individual situation at each institution varies, some of the deficiencies noted were:

- System security parameters that either did not follow best practices or the institution information systems security policies and standards. Examples of these were password length, password change intervals, password history, and system auditing.
- Accounts that have excessive, incorrect rights or that were configured to circumvent system security parameters.

- Accounts that belong to terminated users or that have not been used for a long period of time that could be used by unauthorized individuals to attempt to gain access to the system.

Recommendation

The information security practice standards for each institution should be properly documented and consistently followed to facilitate protecting the integrity and the confidentiality of the information within the information systems. Valid exceptions to the standards should be documented to provide the basis for what an acceptable practice is, such as the flexibility needed on password parameters for generic training, system accounts, and special purpose accounts. Periodic reviews should be performed to ensure terminated or dormant accounts are removed or disabled in the systems.

Management Response

System management agrees with the recommendation. In conformance with TAC 202, Business Procedure Memorandum 53 was created to provide the institutions guidance in developing policies that meet state and federal regulatory requirements. System management will convene the Chief Information Officers of the institutions to discuss the issues around uniform information security and develop recommendations for institutional management to require uniform practices.

MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, THE INTERNAL CONTROL

The following comments concerning management's responsibility for the internal control and the objectives of and the inherent limitations of the internal control are adapted from the Statements on Auditing Standards of the American Institute of Certified Public Accountants.

Management's Responsibility

Management is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control.

Objectives

The objectives of internal control are to provide management with reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with the applicable laws and regulations.

Limitations

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.