The University of Texas System

Report to Management for the Year Ended August 31, 2006

Deloitte.

Deloitte & Touche LLP
Suite 1700
400 West 15th Street
Austin, TX 78701
USA

Tel: +1 512 691 2300
www.deloitte.com

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

Dear Members of the Audit, Compliance, and Management Review Committee:

In planning and performing our audit of the consolidated financial statements of The University of Texas System (the "System") for the year ended August 31, 2006 (on which we have issued our report dated December 4, 2006), we considered its internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the System's internal control. However, we noted a matter involving the System's internal control and its operation that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the System's internal control that, in our judgment, could adversely affect the System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition that we noted is described below.

Classification of Net Assets

Observation—Net assets of approximately $7.8 billion classified in prior years as restricted nonexpendable should have been classified as restricted expendable net assets in accordance with the accounting standards promulgated by the Governmental Accounting Standards Board. Although the misclassification did not result in a misstatement of total net assets, it did result in a restatement of the System's 2005 financial statements to properly reflect the appropriate classification of restricted expendable and restricted nonexpendable amounts.

Recommendation—The initial misclassification of net asset balances was the result of a misinterpretation of complex accounting guidance. The System employs a number of individuals throughout the organization who possess knowledge of specific types of transactions and financial reporting requirements; we recommend that the System Controller's office consider utilizing these individuals as part of the financial statement reporting process or as issues arise.

Management's Response—The rationale for the historical classification was the set payout on the majority of endowment balances that are invested in the General Endowment Fund ("GEF") and the formula-generated set payout on the Permanent University Fund per the Texas constitution. The guidance followed for the endowments invested in the GEF was the Uniform Management of Institutional Funds Act ("UMIFA"), Chapter 163, Texas Property Code, as amended, which states that the Board of Regents may distribute, for the uses and purposes for which the endowment funds are established, the net appreciation, realized and unrealized, in the fair market value of the assets of the endowment over the historical dollar value of the fund to the extent prudent under the standard provided by Section 163.007 of the Act.

Since it was unlikely that all of the endowment appreciation would be authorized for distribution, and in fact, it would not be prudent, these net assets were viewed as restricted nonexpendable. GASB guidance does not refer to the fact that a university will distribute the appreciation on endowment holdings; it instead focuses on the fact that it could distribute the earnings.

In fiscal year 2006, a disclosure committee was formed as part of the year-end reporting process. The committee included representatives from throughout the System and members of the external audit firm. The University of Texas Investment Management Company will be represented on the committee in the future.

New accounting pronouncements are reviewed, summarized, and disseminated throughout System accounting and financial reporting for discussion and comment. Other experts, both internal and external to System, are involved as appropriate.

Our consideration of the System's internal control would not necessarily disclose all matters in the System's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. The reportable condition described above is not believed to be a material weakness.

We also submit our comments concerning certain observations and recommendations relating to other accounting, administrative, and operating matters. These recommendations resulted from our observations made in connection with our audit of the System's consolidated financial statements for the year ended August 31, 2006. Our comments are presented in Exhibits I and II.

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 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

FINANCIAL AND ACCOUNTING OBSERVATIONS

Tuition and Fees Receivable—Internal (Academic Institutions)

Observation—During our testing of tuition accounts receivable, we noted that certain special billing amounts (related to inter-departmental third-party billings and waiver/exemptions) were included in the balances; however, the full amount of these special billings will not be collected from an external source. The amounts were not eliminated in consolidation; therefore, accounts receivable and deferred revenue of approximately $48 million were overstated at fiscal year-end for amounts that potentially will not be collected from an external party.

Recommendation—Identify all internal accounts receivable and record an adjusting entry or an eliminating entry at fiscal year-end to reduce the tuition accounts receivable and deferred revenue by the amount of internal receivables recorded within the general ledger.

Management's Response—We concur. Eliminating entries will be recorded at fiscal year-end.

Update on Federal and Non-Federal Research Grants (UT Medical Branch at Galveston)

Observation—During fiscal 2004, management discovered that there were numerous grants administration accounting and compliance issues around federal and non-federal contracts and grants. Management hired a consulting firm to address and resolve the accounting and compliance issues. The focus of the consulting firm's work was on process improvement. In 2006, management established an internal project team to implement the consulting firm's process improvement changes and recommendations.

In our management letter for the fiscal year 2005 audit, we recommended that management's new 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 accurate and appropriate.

During fiscal year 2006, the project team worked with Institutional Compliance, Research Services, Finance, and the consulting firm to address the recommendations, including reviewing, updating, and improving the processes related to internal controls, reconciliations, timely draws for reimbursement, and accurate reporting. The Balance Forward Project was initiated to validate all contracts and grants revenue and expense transactions in the PeopleSoft system from 2003 to the present. The results of this project established a high level of confidence that the transactional data posted to the general ledger is correct. Additionally, communication continues with federal sponsors, and recommended reviews and changes have occurred accordingly.

The processing of revenue, billing, and accounts receivable for current expenditures appears to be working as redesigned, and the reconciliation and review of outstanding billed and unbilled accounts receivable continues to be an ongoing process. Quality assurance and quality control reports continue to be reviewed and enhanced to ensure that revenue and accounts receivable are properly recorded and that cash draws made against the federal letters of credit and all billings are correct. The reconciliation project continues to identify adjustments to prior-period recorded revenue and accounts receivable recorded; however, management is confident that the current processes are working appropriately.

Recommendation—We recommend that management continue its efforts to ensure that effective contracts and grants accounting, management, and compliance processes are in place and working as intended.

Management's Response—University of Texas Medical Branch ("UTMB") management concurs with this recommendation and will continue the efforts of the internal project team to continue ensuring effective contracts and grants accounting, management, and compliance.

With the redesigned processes in place and functioning as intended, UTMB has addressed the issues previously identified and no further updates will be required.

INFORMATION TECHNOLOGY OBSERVATIONS

Change Management Controls and Testing Procedures*

Observation—Inconsistent change management control procedures in design and implementation caused several institutions to have deficiencies in their processes. The institutions have made progress; however, there are still weaknesses in certain areas. Although the individual situation at each institution varies, some of the common deficiencies noted included:

- Overall change management related to key applications is generally informal in nature and either is not consistently documented or not documented at all.
- Documentation of the testing details is not maintained.
- No system is in place to provide the functionality to log the approval of changes and testing details.

Recommendation—Management should standardize and enforce formal change management policies and procedures. These procedures should detail general testing and approval procedures required to be performed. Additionally, management should indicate what types of supporting documentation should be maintained and how long it should be maintained. Management should consider implementing formal internal auditing processes to verify that the testing policies and procedures are being executed properly.

Management's Response—Management agrees with the recommendation and has revised Business Procedures Memorandum ("BPM") 53 to require all System institutions and System Administration to adopt change management processes that include procedures for:

- Formally identifying, classifying, prioritizing, and requesting changes
- Identifying and deploying emergency changes
- Assessing potential impacts of changes
- Authorizing changes
- Testing changes
- Change implementation and back-out planning
- Documenting and tracking changes

The revised BPM is expected to be approved in spring of 2007. All System institutions and System Administration will be required to comply with the revised BPM sixty days after the approval date.

Logical Access

Observation—Exceptions were noted for terminated employees having active access and active employees having excessive access based on their current job responsibilities.

Recommendation—The termination of an employee should require a change in the status of access privileges associated with his or her user account. In addition to the cleanup effort for the current exceptions, these changes should be performed immediately upon the change of the employee's status. Periodic user access reviews, based on information obtained from the human resources department and based on defined criteria for access to system privileges (e.g., Operations and Special), should ordinarily be performed by management to ensure that necessary changes have been made.

Management's Response—Management agrees with the recommendation and has revised BPM 53 to require all System institutions and System Administration to adopt access management processes that include reviewing, removing, and/or disabling accounts on a periodic basis to reflect current user needs or changes in user role or employment status. The revised BPM is expected to be approved in spring of 2007. All System institutions and System Administration will be required to comply with the revised BPM 60 days after the approval date.

System, Database, Application, and Network Security*

Observation—Although steps have been taken to increase security, during our review of application, database, and system software security, we noted several exceptions related to minimum password length, password complexity, password change intervals, failed login attempts, and other security settings specific to each system. In addition, we noted that password parameters are not being implemented consistently.

Recommendation—Password parameters and other settings should be set to follow industry practices or institutional policies to ensure integrity of data and protection of sensitive information, including administrator-level accounts. For systems where the password controls cannot be imposed, management should implement controls, such as periodic monitoring of password strength.

Management's Response—Management agrees with the recommendation and has developed an Action Plan to Enhance Information Security Compliance. The action plan requires System institutions and System Administration to develop an Information Security Program with specific strategies for owners of significant and critical information assets to identify and manage risks to data integrity and the protection of sensitive data. The revised BPM requires that password policies, standards, and procedures include procedures for establishing password strength and changing passwords. The revised BPM is expected to be approved in spring of 2007. All System institutions and System Administration will be required to comply with the revised BPM 60 days after the approval date. The System-wide Chief Information Security Officer will develop guidance on password and security settings.

EXHIBIT II

FINANCIAL AND ACCOUNTING OBSERVATIONS—BEST PRACTICES AND FORWARD-LOOKING COMMENTS

Monthly Reporting*

Observation—Certain account balances at various institutions are reconciled on only an annual basis. These accounts include, but are not limited to, capital assets; student, pledge, and other receivables; prepaid expenditures; and accrued expenses and notes payable. If significant adjustments are not processed throughout the year, balances and activity are not accurately portrayed on an interim basis.

Recommendation—We did not note any material accounts in need of adjustment; however, depending upon the costs and benefits of making more frequent accruals, management should consider performing adjustments at least on a quarterly basis for significant accounts. This would increase the efficiency with which the year-end balances can be derived and would lessen the likelihood of errors occurring at year-end.

Management's Response—We concur. Based on cost/benefit analysis, management will consider making material adjustments on a more frequent basis.

Mapping From Trial Balance to Annual Financial Report

Observation—We noted at multiple institutions that the mapping of the general ledger to the financial statements has general ledger account balances flowing into multiple financial statement line items, since the general ledger accounts are based on natural classification, and the financial statement line items are based on the functional classification.

Recommendation—Since this mapping is complex and not intuitive, we recommend that management streamline the mapping from the general ledger to the annual financial report for both the balance sheet and income statement, and continue to challenge the account layout of the general ledger to simplify the mapping.

Management's Response—One of the five key initiatives in *The University of Texas System Strategic Plan 2006-2015* is improving productivity and efficiency. As part of this initiative, a strategy is to implement shared services among the institutions. A chart of accounts consolidation plan is being developed that will allow for more efficient reporting of financial data at the institutional and consolidated levels, which would result in improved consistency of the account layout and therefore more streamlined mapping to the financial statements. The plan is expected to be completed this fiscal year with implementation of the plan to be completed in fiscal year 2009.

Consideration of Potential Component Units

Observation—GASB No. 39, *Determining Whether Certain Organizations Are Component Units*—an amendment of GASB Statement No. 14, contains the following criteria for assessing whether potential component units should be included in the System's financial statements:

- The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.

- The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

- The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

The System has several foundations that meet the first two criteria. The third criterion essentially requires that the resources of the potential component unit be significant to the System; System management has determined that none of the foundations are significant to the System at this time.

Recommendation—Although the System does not currently have any component units that meet the criteria for inclusion in its consolidated financial statements, it should, on an annual basis, continue to closely monitor the significance of these potential component units to ensure that none meet the criteria in GASB Statement No. 39.

Management's Response—Each year, an evaluation of potential component units ("PCU") is performed to determine whether any should be included in the consolidated financial statements as either blended or discrete component units. An extensive questionnaire is completed for each PCU, addressing the criteria in GASB Statement No. 39, including whether it is legally separate from the System; who appoints the voting majority of the PCU's board; and the nature of the PCU's relationship with the System, including control and specific financial benefits to or burdens on the System. PCUs are also evaluated to determine whether, if excluded, financial statements could be misleading or incomplete based on comparing the PCU's net assets to 5% of the System's net assets of approximately $11.6 billion.

Based on the analysis of nearly 50 entities with net assets totaling more than $1.3 billion, it was determined that none required inclusion in the consolidated financial statements. Individually, each PCU was less than 2.24% of the System's net assets.

UPCOMING ACCOUNTING PRONOUNCEMENTS

GASB Statement No. 45: Other Postemployment Benefits

Observation—The GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* which will be effective for the System in fiscal year 2008. This statement requires that state and local governments establish standards for the measurement, recognition and display of other postemployment benefits expense/expenditures, related liabilities and note disclosures in the financial statements.

GASB Statement No. 48: Sales and Pledges of Receivables and Future Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues

Observation—The GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. This statement is effective for the System beginning in fiscal year 2008. This statement establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The statement also requires enhanced disclosures pertaining to future revenues that have been pledged or sold, provides guidance on sales of receivables and future revenues within the same financial reporting entity, and provides guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

GASB Statement No. 49: Pollution Remediation Obligations

Observation—The GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations,* in December 2006. The statement will be effective for the System beginning in fiscal year 2009. This statement identifies the circumstances under which a governmental entity is required to report a liability related to pollution remediation. A government is required to estimate expected outlays for pollution remediation using an "expected cash flows" measurement technique if it knows a site is polluted and if any of the predefined recognition triggers occur. Information about pollution obligations associated with cleanup efforts should also be disclosed in the notes to the financial statements.

Recommendation—Review GASB Statement Nos. 45, 48, and 49 and their implications to determine the potential impact on the System's financial statements.

Management's Response—New accounting pronouncements are reviewed, summarized, and disseminated throughout System accounting and financial reporting for discussion and comment. Other experts will continue to be involved as appropriate.

*Indicates that a recommendation was also communicated in the prior year and remains an observation in the current year.

APPENDIX

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.