AGENDA

COMMITTEE ON AUDIT

Meeting: 4:00 p.m., Tuesday, March 11, 2003
California State University
Titan Student Union, Portola Pavilions B & C

Shailesh J. Mehta, Chair
Kyriakos Tsakopoulos, Vice Chair
William Hauck
Dee Dee Myers
Erene S. Thomas
Anthony M. Vitti

Consent Items

Approval of Minutes of Meeting of January 29, 2003

Discussion Items

1. Status Report on Current and Follow-up Internal Audit Assignments, Information
2. Report of the Systemwide Audit in Accordance with Generally Accepted Accounting Principles Including the Report to Management, Information
MINUTES OF THE MEETING OF COMMITTEE ON AUDIT

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

January 29, 2003

Members Present
Shailesh J. Mehta, Chair
Kyriakos Tsakopoulos, Vice Chair
William Hauck
Erene S. Thomas

Members Absent
Dee Dee Myers
Anthony M. Vitti

Other Trustees Present
Debra S. Farar, Chair of the Board
Roberta Achtenberg
Robert Foster
Murray L. Galinson
Harold Goldwhite
M. Alexander Lopez
Ralph R. Pesqueira
Frederick W. Pierce, IV
Charles B. Reed, Chancellor
Martha Walda

Chancellor’s Office Staff
Louis Caldera, Vice Chancellor, University Advancement
Christine Helwick, General Counsel
Dennis Hordyk, Assistant Vice Chancellor, Financial Services
Larry Mandel, University Auditor
Jackie McClain, Vice Chancellor, Human Resources
David S. Spence, Executive Vice Chancellor and Chief Academic Officer
Richard P. West, Executive Vice Chancellor and Chief Financial Officer
Audit

Chair Mehta called the meeting to order at 8:42 a.m.

Approval of Minutes

The minutes of the meeting of November 12, 2002, were approved as submitted.

Status Report on Current and Follow-up Internal Audit Assignments

Mr. Larry Mandel, university auditor, presented the item by reporting the status of the following audit assignments and follow-up reviews:

FISMA – Six audits have been completed, report writing is being completed on three campus reviews, and fieldwork is currently taking place at three campuses.

Auxiliary Organizations – Two campus/five auxiliary reviews have been completed, two campus/seven auxiliary reviews await a response prior to finalization, and report writing is being completed on two campus/nine auxiliary reviews.

Financial Aid – Three campus reviews have been completed, five audits await a campus response prior to finalization, and report writing is being completed on two campus reviews.

Disability Support and Accommodations – Five campus reviews have been completed, two audits await a campus response prior to finalization, and report writing is being completed on three campus reviews.

Development – Eight campus reviews have been completed, one audit awaits a campus response prior to finalization, and report writing is being completed on one campus.

As per the audit plan, audits will be performed for the subject areas at about ten campuses each this year – approximately 29 auxiliary organizations and 12 FISMA areas.

Follow-up – Currently tracking approximately 35 prior audits (Special Investigations, FISMA, Auxiliary Organizations, Development, Contracts and Grants, and Delegations of Authority) to determine the appropriateness of the corrective action taken for each recommendation and whether additional action is required.

Construction – For fiscal year 2001/02, six construction projects have been completed by KPMG with coordination from the Office of the University Auditor. Follow-up reviews are currently in process for these projects. Current construction assignments for 2002/03 are on schedule. Two of these projects are in the report-writing stage, and one project is in the fieldwork stage.
Mr. Mandel stated that all of the audit assignments for 2002 have been completed, with the exception of auxiliary organizations, which are still somewhat running behind schedule due to the diversion of resources to complete unplanned investigations. He indicated that all the campuses are making significant progress towards completing the recommendations. However, three campuses have outstanding recommendations at or beyond the 12-month period and the Office of the University Auditor (OUA) has been assisting them with the closing of these recommendations.

Chair Mehta inquired as to the reason for the difference in the number of recommendations for subject areas (FISMA, Development, etc.) versus auxiliary organizations.

Mr. Mandel explained that there are two factors influencing the perceived large number of recommendations: (1) this is the first cycle of auxiliary reviews. As we move forward, it is expected that the number of recommendations will decrease much the same as the FISMA review recommendations have decreased over time (this is our sixth cycle of reviews); and (2) there are between two and six auxiliary organizations at each of the twenty-three campuses and multiple reviews are performed at one time. He further explained that in addition to the auxiliary organizations, an overall review of the campus is performed, which increases the number of recommendations. To get a more accurate view, the number of recommendations should be divided by the number of auxiliaries plus one (for the overall review).

**Assignment of Functions to be Reviewed by the Office of the University Auditor for Calendar Year 2003**

Mr. Mandel explained that at the January meeting of the Board of Trustees, The Committee on Audit selects the three subject area audit assignments for the OUA and approves the audit plan for the year. He further explained that in addition to the subject area assignments, financial internal control (FISMA) reviews; Auxiliary Organization reviews; and construction reviews, which are performed by KPMG, are planned for calendar year 2003.

Mr. Mandel stated that a risk assessment, which is conducted once every three years, was completed in the last quarter of calendar year 2002. He further stated that the results of the 2002 risk assessment were used to assist in the selection of the audit assignments. He explained that Audit Item 2, Attachment A, lists 29 prospective audit topics that represent the top 50 percent of risk and indicates the time last audited by the OUA. Based on the risk assessment, subject areas reviewed in the recent past, and discussion with the Executive Audit Committee, which is represented by four California State University (CSU) presidents and the executive vice chancellor/chief financial officer, the following three subject areas were recommended for consideration for calendar year 2003: Employees Relations, Disaster and Emergency Preparedness, and Risk Management and Insurance.
Audit

Chancellor Reed expressed his support for the three recommended subject area assignments. He emphasized the importance of disaster and emergency preparedness and stated that the emergency preparedness plans at all 23 campuses are currently being reviewed by a consultant. He stated his belief that a review of employee relations, specifically contracts, and of risk management and insurance would be beneficial.

Chair Mehta called for a motion to approve the Committee resolution. A motion was then made and the resolution was passed unanimously to approve the audit plan for 2003.


Mr. Mandel presented the item by explaining that, per CSU’s contract with KPMG, six construction reviews have been completed. Mr. Mandel then introduced Mr. Mark Thomas, partner in charge from KPMG, who discussed the construction assignments for 2001/2002.

Mr. Thomas explained that KPMG performs post-completion construction reviews with coordination from the Office of the University Auditor. He further explained that once the construction project has been completed, KPMG begins its audit by visiting the site of the contractors and reviewing documentation relating to the project. He indicated that the six projects reviewed for fiscal year 2001/02 represented approximately $110 million and that these reviews included projects at the San Bernardino, San Diego, San Francisco, and Stanislaus campuses. He further indicated that the findings and recommendations included in the report pertain to construction policies, change orders, accounting issues, and request for proposal issues.

Mr. Thomas stated that campus management has agreed with 37 of the 38 recommendations and is in the process of completing the recommendations. Follow-up reviews will be performed by the OUA. He further stated that there is a disagreement with one recommendation pertaining to a judgment call regarding the level of documentation received in a specific situation, but it has no ongoing significance.

Mr. Thomas stated that KPMG is currently reviewing construction projects for 2002/03. He indicated that the areas of emphasis include the bid process, subcontracting practices, project management, accounting, liquidated damages, major equipment purchases, design costs, and change orders.

Chair Mehta inquired as to the process of reviewing change orders.

Mr. Thomas explained that the review process for change orders includes determining whether proper procedures were followed in obtaining the change order, determining whether it is well-documented, determining the reasons for the change order, and reviewing the change orders and percentage in relation to the entire contract, comparing it to industry norms.
Report of the Systemwide Audit in Accordance with Generally Accepted Accounting Principles Including the Report to Management

Mr. Richard P. West, executive vice chancellor/Chief Financial Officer, explained that this year new governmental accounting standards were introduced, which were quite substantial in their changes and impact on the financial statements. He indicated that due to the late distribution of the financial statements, Mr. Mark Thomas, partner in charge from KPMG, would provide an overview of the financial statements but would return at the March meeting for more discussion on this item.

Chancellor Reed commended Dennis Hordyk, assistant vice chancellor, financial services, Mr. West’s staff, and the campus accounting and business offices for their efforts to complete this audit while at the same time implementing new financial information system software and performing year-end closing.

Mr. West introduced Mr. Thomas, who presented the item.

Mr. Thomas presented a brief history of GASB, the Governmental Accounting Standards Board, which was created in 1984. In 1984, GASB was charged with relooking at the government financial reporting model and making it more meaningful. In November of 1999, GASB introduced a new model and issued a series of GASB statements referred to as GASB 34, 35, 37, and 38. These four statements completely changed the way that governments report their financial condition. He stated that this is the most comprehensive change in governmental financial reporting in over 50 years. Because of the size of the CSU and the fact that it’s an agency of the state of California, the CSU was required to implement the new standard in the first year.

Mr. Thomas explained the significant changes in the financial statements between last year and this year. The first change is the inclusion of Management’s Discussion Analysis, which was modeled after Securities and Exchange Commission reporting companies. The second change pertains to the introduction of a single-column format, which provides the university financial information in one column as compared to the previous format of five or six columns. One of the biggest changes is that now depreciation is recorded on fixed assets, which was a $3-billion hit to CSU’s financial condition. Other changes pertain to assets and liabilities, which are now classified as current and noncurrent, and revenues and expenses, which are now classified as operating and nonoperating.

Mr. Thomas presented an overview of the financial statements. He stated that Management’s Discussion and Analysis addresses the new accounting and reporting standards as well as some of the highlights of the organization for the year. It also provides condensed, summary level financial statements for both the university and the auxiliary organizations and includes a graph of revenues and expenses, showing the sources of funding and where funds are expended. In addition, the topics of capital assets are addressed as well as a brief discussion of the current
CSU budget situation. Lastly, it provides information on the new Systemwide Revenue Bond program, in which some $350 million in debt was just issued. In the future, the Management’s Discussion and Analysis will provide a year-to-year financial comparison.

Mr. Thomas stated that the Independent Auditors’ Report provides a clean opinion on the CSU’s financial statements and discusses the implementation of new accounting standards. He explained that the Statement of Net Assets is the equivalent of the balance sheet in a corporate organization and shows total net assets of approximately $3.3 billion. He further explained that the single-column format includes a column for the university proper, which includes all the campuses and the chancellor’s office, and a separate column for the auxiliary organizations, which includes some 82 auxiliary organizations. He explained that the first line item under Net Assets, Invested in Capital Assets, Net of Related Debt, represents total capital assets, or fixed assets, minus the debt to finance those assets. He stated that of the total $3.2 billion in net assets, $2.2 million is tied up in fixed assets, net of the related debt.

Mr. Thomas stated that auxiliary organizations, consisting mostly of foundations, have a significant amount of cash and investments because they hold most of the endowment assets of the reporting entity. He further stated that the auxiliary organizations have significant capital assets because they have significant buildings and significant amount of debt. When you compare their long-term debt of $516 million to the bonded debt of the university of $782 million, he stated that it’s a significant amount of debt.

Mr. Thomas explained that the Statement of Revenues, Expenses, and Changes in Net Assets is the equivalent of the income statement. He indicated that state appropriations are not considered by the standard to be an operating revenue but more of an operating subsidy and, as a result, comes under the nonoperating section. He stated that the statement indicates $2.6 billion in state appropriations and capital state appropriations for another $178 million.

Mr. Thomas indicated that depreciation in the current year cost the CSU $219 million, in addition to the almost $3-billion catch-up adjustment that was implemented as per the new standard. He stated that the university’s net assets increased $260 million this year, primarily as a result of capital-related state appropriations and grants.

Mr. Thomas stated that at the March meeting, he will discuss the Management Letter of the system and indicated that the Management Letter would include significant comments related to the internal controls in the finance and accounting area. He expressed his concern regarding the significant staff turnover that occurred as a result of the concurrent implementation of the new accounting standards in addition to the accounting system.

Chair Mehta commended Mr. Thomas on his presentation of the financial statements.

Trustee Hauck asked if this type of presentation would have been possible without the change in the accounting system.
Mr. Thomas responded that it would have been ultimately possible, but was unsure of the timing, due to so many resources also committed to going through the accounting system change at the same time.

Trustee Hauck inquired as to whether any of the campuses would have been in compliance with GASB standards using the old system or systems.

Mr. Thomas responded that GASB standards would not have been met without significant manual adjustment to the system.

Trustee Hauck inquired as to the consequence of not complying with GASB standards.

Mr. Thomas responded that KPMG would not be able to issue a clean opinion on the financial statements.

Trustee Galinson asked if the depreciation is an accelerated depreciation and whether the assets are really worth more than they are recorded on the books.

Mr. Thomas explained that current accounting standards require the recording of assets at their historical cost.

Trustee Galinson inquired as to whether it would be more beneficial if the auxiliaries and CSU had one auditing firm performing reviews.

Chancellor Reed responded to Trustee Galinson by indicating that he did not think it would be more beneficial because of the enormity of the task. He stated that there has been a tremendous improvement in the auxiliary organizations as a direct result of performance audits conducted by the OUA in the last five years. He then asked for Mr. Thomas’ comments on this.

Mr. Thomas explained that approximately 25 CPA firms perform the financial reviews of the auxiliary organizations in addition to KPMG’s involvement, resulting in different opinions and formats of financial statements. He further explained that KPMG reviews the financial statements for reasonableness of presentation and ensures that the auditors have very clear guidelines on financial statement formats and presentations.

Mr. Thomas agreed with Chancellor Reed that there is a significant improvement in auxiliary organizations today than five years ago. He noted that the OUA has reported numerous findings from their reviews of the auxiliary organizations. As a result, there are now controls, procedures, and written agreements in place that were not there five years ago.

Trustee Hauck inquired as to the capabilities of the 25 CPA firms that assist with the review of the financial statements.
Audit

Mr. Thomas explained that most of them are small, local firms. He further explained that KPMG is required to confirm each of the firm’s independence and to ensure that the firms understand that their reports will be referenced in the opinion. However, he did note that KPMG does not specifically evaluate their qualifications.

Trustee Hauck requested that Mr. Thomas inform the Committee if any one of the CPA firms were not performing in the appropriate manner.

Trustee Pierce asked if the following was a correct assessment: An internal team, together with KPMG, looked at the useful life of different categories of the system’s assets and came up with either 30, 40, or 50 year lives and then accrued accumulated depreciation based upon when those improvements were constructed to make the adjustment for this year’s financial statements?

Mr. Thomas responded affirmatively and stated that the beginning of the year adjustment is $2.9 million.

Trustee Pierce asked if we are marking to market our investment portfolio.

Mr. Thomas responded that each of the auxiliary organizations is a separate 501(c)3 not-for-profit organization. He stated that the auxiliary organizations are required by accounting standards to mark their investment portfolios to market. He further stated that the changes in their portfolio value are included in the Statement of Revenues, which shows investment income of $1.2 million and an investment loss of $5.2 million. He indicated that the rest of it is actually reported under Other Nonoperating Revenue at a loss of $73 million.

Chair Mehta asked Mr. Thomas and Mr. West for comments regarding the impact this new statement will have on the CSU’s ability in getting the rating for new debt.

Mr. Thomas responded that even the state and local governments had to implement or will have to implement the new format of this statement over the next three years. In addition, this statement is also new to the rating agencies. He explained that many of the entities are falling into a net liability position; CSU has a net asset position, resulting in strong financial statements in this area.

Mr. West responded that in early December or mid-December, a meeting was held with the rating agencies in anticipation of the $345-million issue. The rating agency reviewed the draft financial statements and was comfortable with it. In addition, he indicated that the debt issue and the governor’s budget were discussed extensively with the rating agency at the December meeting, and they have been kept up to date on these issues.

Mr. West acknowledged and complimented the substantial effort that everyone has put forth in completing the financial statements, including the outside audit firms who assisted with the collection of information and assessment of depreciation activities.
Mr. West went on to explain that the statements reflect all funds, not just the General Fund. He stated that all funds means anything that is derived from fees, which includes student housing. He also noted that we had to have those monies in reserve to protect our debt instruments and the fees paid by students for housing and also for student unions. So, there are a lot of dollars here that aren’t the General Fund, and this is the best way for a Trustee to understand the financial condition of the entity that you govern. That isn’t to say we have flexibility with all these funds. The underlying restrictions of the fund source is still the powerful control. So, the General Fund is deficient in our funding requirement. There’s obviously nothing in investments that are the General Fund. All investments are associated with trust funds or fee-based funds or gifts or grants.

Mr. West also noted that auxiliary debt is being reduced over time as we look to systemwide revenue bonds at lower carrying costs.

Mr. West further noted the discussion of risk management in the footnotes. He stated that even though our costs have gone up substantially for risk—workers’ compensation, liability, and property—we are still underfunded from a coverage perspective. While there are $39.5 million of reserves in that area, the obligation is estimated by the auditors to be in the $60-million range. So, we have great exposure, but I think overall you should feel comfort in that the institution is in good financial health. As far as its exposure to debt, its exposure to risk, it isn’t to say that we’re in the best health. We have to improve in the risk area; we have to do better in our maintenance and our buildings. I would think, if anything, we have not kept up our deferred maintenance activity, so we are probably exposed in that area.

Trustee Hauck expressed his appreciation for the outstanding work in preparing these financial statements and particularly for the improvements with the auxiliary organizations.

Chair Mehta expressed his concern as to who would ensure that the auxiliary organizations are complying with the recommendations of their outside auditors.

Mr. West stated that he understood the importance of following up with the auxiliary organizations regarding the recommendations.

**Single Audit Report of Federal Funds**

The discussion of the Single Audit Report was postponed until the March 2003 meeting.

**Adjournment**

The meeting was adjourned at 9:37 a.m.
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 2003 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, Employee Relations, Risk Management and Insurance, Disaster/Contingency Planning, Information Systems, and Construction. In addition, follow-up on past assignments (Special Investigations, FISMA, Auxiliary Organizations, Development, Contracts and Grants, Delegations of Authority, Financial Aid, and Disability Support and Accommodations) is currently being conducted on approximately 55 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 2003 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, Employee Relations, Risk Management and Insurance, Disaster/Contingency Planning, Information Systems, and Construction.

FISMA

The audit plan indicated that approximately 136 staff weeks of activity (17 percent of the plan) would be devoted to auditing financial internal controls on 12 campuses. Report writing is being completed on two campus reviews, while fieldwork is currently taking place at four campuses.

Auxiliary Organizations

The audit plan indicated that approximately 261 staff weeks of activity (32 percent of the plan) would be devoted to auditing internal compliance/internal control at 9 campuses/29 auxiliaries. Fieldwork is currently taking place at two campuses/five auxiliaries.
Employee Relations

The audit plan indicated that approximately 97 staff weeks of activity (12 percent of the plan) would be devoted to a review of 10 campuses on activities involved in negotiating and administering collective bargaining agreements with represented employees, administering the management personnel plan for nonrepresented employees, and the systems for addressing staff grievances and complaints. The audit program for this subject is currently being field tested by the audit manager in charge of the project.

Risk Management and Insurance

The audit plan indicated that approximately 97 staff weeks of activity (12 percent of the plan) would be devoted to a review of 10 campuses on risk and liability assessments, self insurance, selection of insurance coverage and carriers, risk mitigation and prevention programs, claims review and processing, and operations of the California State University Risk Management Authority. The audit program for this subject is currently being field tested by the audit manager in charge of the project.

Disaster/Contingency Planning

The audit plan indicated that approximately 97 staff weeks of activity (12 percent of the audit plan) would be devoted to a review of 10 campuses on 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. The audit program for this subject is currently being field tested by the audit manager in charge of the project.

Information Systems

The 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 30 staff weeks of activity (4 percent of the plan) would be devoted to follow-up on prior audit recommendations. The Office of the University Auditor is currently tracking approximately 55 prior audits (Special Investigations, FISMA, Auxiliary Organizations, Development, Contracts and Grants, Delegations of Authority, Financial Aid, and Disability Support and Accommodations) to determine the appropriateness of the corrective action taken for each recommendation and whether additional action is required.

Consultations and Investigations

The audit plan indicated that approximately 43 staff weeks of activity (5 percent of the plan) would be devoted to campus consultations and special requests. 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. Typically, the special requests are investigative in nature and often are the result of alleged defalcations or conflicts of interest.

Construction

The audit plan indicated that approximately 5 staff weeks of activity (1 percent of the plan) would be devoted to coordination of construction auditing. For the 2002/03 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. Report writing is being completed on four projects, while fieldwork is currently taking place on one project.

Training

The audit plan indicated that approximately 10 staff weeks of activity (1 percent of the plan) would be devoted to training in control self-assessment. The program consists of a two-day workshop where risk assessment/mitigation and internal control training will be provided and a targeted risk assessment profile will be developed. In addition, the Office of the University Auditor is planning two, one-day workshops on various aspects of audit coordination and process.
Status Report on Current and Follow-Up Internal Audit Assignments  
(as of 2/21/2003)

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<td>FW</td>
<td>10 8/9 4/8 8</td>
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</tbody>
</table>

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 placeholder 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.

**The number of months recommendations have been outstanding (since the formal campus exit conference).

• The number of auxiliary organizations reviewed.
<table>
<thead>
<tr>
<th>Project No.</th>
<th>Project</th>
<th>Contractor</th>
<th>Project Cost</th>
<th>Start Date</th>
<th>Comp. Date</th>
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<th>Current</th>
<th>Follow-Up</th>
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<td>HUM Infrastructure Improvements</td>
<td>Mallcraft, Inc.</td>
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<td>West Coast Contract</td>
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<td>Swinerton Walberg</td>
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**The number of recommendations satisfactorily addressed followed by the number of recommendations in the original report.
***The number of months that recommendations have been outstanding (since the formal exit conference).
COMMITTEE ON AUDIT

Report of the Systemwide Audit in Accordance with Generally Accepted Accounting Principles Including the Report to Management

Presentation By

Dennis Hordyk
Assistant Vice Chancellor
Financial Services

Summary

The systemwide audit in accordance with generally accepted accounting principles was distributed and discussed at the last Board meeting. Representatives from KPMG Peat Marwick, the external audit firm hired by the California State University to conduct the audit, will be available at this meeting to respond to any further questions and discuss their report to management.
COMMITTEE ON AUDIT

Single Audit Report of Federal Funds

Presentation By

Dennis Hordyk
Assistant Vice Chancellor
Financial Services

Summary

The single audit report of federal funds and the related management letter for all campuses and the Chancellor’s Office will be reviewed and discussed at the meeting. Representatives from KPMG Peat Marwick, the external audit firm hired by the California State University to conduct the audit, will be available to respond to questions.