Audit Oversight Committee Report

On June 29, 2009, President Kirk Schulz and Athletic Director John Currie held an open campus forum to answer questions about the then-recently released Grant Thornton Exit Analysis regarding former President Jon Wefald's retirement ("Grant Thornton report").

Growing out of that forum, President Schulz appointed a twelve-member committee ("the Committee") on August 5, 2009, to evaluate the issues raised in the Grant Thornton report, to determine the status of the University's operations as they relate to the concerns in that report, and to make further recommendations.

The members of the Committee include: Brian Spooner (Chair), University Distinguished Professor and interim Dean, College of Arts and Sciences; Melody LeHew, Faculty Senate president, College of Human Ecology; Fred Fairchild, Faculty Senate, College of Agriculture; Carolyn Elliott, Classified Senate president, Office of Student Life; Dalton Henry, Student Body president, College of Agriculture; Lori Goetsch, Dean of Libraries; Eric Higgins, Department Head, Department of Finance, College of Business Administration; M.M. Chengappa, University Distinguished Professor (faculty), College of Veterinary Medicine; Les Hannah, K-State at Salina (faculty), College of Technology & Aviation; Reid Sigmon, Department of Athletics (ex-officio); Peter Paukstelis, Office of General Counsel; Lee Borck, External (community), Manhattan; and Jud Neal, External (non-alumnus), Overland Park.

The Committee met on August 28, 2009, and we began review of the Grant Thornton report. The Committee's method included first identifying the issues raised in the report. We then determined which documents we needed to review and which individuals we needed to interview to gain a more complete understanding. We then took steps to obtain the documents and interview the people. Throughout this process, we continuously analyzed, reviewed, and discussed the facts, and our potential recommendations.

The Committee continued meeting regularly, including on September 4, September 11, September 15, September 18, September 30, October 2, October 9, October 16, October 23, October 30, and November 4, 2009.

The Committee interviewed the following individuals regarding issues discussed in the Grant Thornton report: Bruce Shubert, Vice President for Administration and Finance, Kansas State; Alan Klug, Vice President for Administration and Finance, KSU Foundation; Dr. Ron Trewyn, Vice President for Research, Kansas State; Dr. Charles Reagan, Chief of Staff and Deputy to the President, Kansas State; Beth Fancsali and John Luburic, attorneys from Wildman Harrold who were retained by NISTAC to provide an analysis of the Grant Thornton report and to review NISTAC's operating procedures; and Dr. Pat Bosco, Vice President for Student Life and Dean of Students, Kansas State.

The committee has been provided with the following documents related to the Grant Thornton report:

Alumni Association

A letter from Amy Button Renz regarding the statements in the Grant Thornton report related to the Alumni Association

Kansas State University Golf Course Management and Research Foundation ("KSUGCMRF")

A copy of the KSUGCMRF Board of Directors analysis of the Grant Thornton report

A listing of the membership of the KSUGCMRF Board of Directors

The January 1, 2006 operating lease between the KSUGCMRF and Golf Generations

Correspondence between Tim Weiser and Mark Truitt (then President of the KSUGCMRF) regarding the Athletic Department's commitment to pay the KSUGCMRF $20,000 per year

NISTAC

Brief response from NISTAC board regarding the exit audit

Documents relating to KSURF's relationships with NISTAC

NISTAC's 2008 strategic plan

Slides from NISTAC's Sept. 11, 2009 board meeting

NISTAC's conflict of interest policy

2009 Wildman Harrold report

A copy of the materials provided to the KSU Foundation in response to the Grant Thornton report that includes:

1998 State Science and Technology Institute Review

Memo from Ron Sampson to Kent Glasscock regarding the structure and governance of NISTAC

Memo from Ron Sampson to Kent Glasscock regarding NISTAC's responses to the 2006 Wildman Harrold report

Listing of Directors for NISTAC and affiliates

Summary of Manhattan Holdings, LLC financials

Directors for NISTAC's client companies

NISTAC organizational chart

NISTAC or MTM memberships in outside corporations

Athletics

Bylaws for the newly restructured K-State Athletics, Incorporated

A copy of the "K-State Athletics Pledge"

List of the 13 missing transactions noted in the audit with reconciliation as to the payees

Former bylaws of The Intercollegiate Athletic Council of Kansas State University, Inc. ("the IAC").

Bob Krause overload payment approvals and memo from Dr. Jon Wefald

Tim Weiser employment agreement

Tim Weiser loan agreement

Tim Weiser separation agreement

Formal agreement between K-State Athletics, Incorporated and Kansas State University

Payment documents regarding January 2008 payment to KSUGCMRF regarding Bill Snyder Founders Club membership

April 25, 2006 letter from Bernie Haney to Bill Snyder regarding payment status

The Committee does not claim that it reviewed all potentially relevant documents or interviewed every relevant person. Instead, the Committee focused on the documents and persons it determined to be most relevant.

The Committee is comfortable that it has a thorough understanding of the issues raised in the Grant Thornton report, and it believes that its evaluation rests on solid footing.

Analysis and Recommendations

Alumni Association

The Grant Thornton report made no conclusions or recommendations regarding the Alumni Association, so we did not review further. We did note that there is an incorrect statement in the Grant Thornton report that the Alumni Association reported to the Vice President for Institutional Advancement. The Alumni Association is a separate entity with its own Board of Directors. The President of the Alumni Association is a member of the new President's Cabinet.

Kansas State University Golf Course Management and Research Foundation

Issues raised by Grant Thornton included: (1) payments of $20,000 per year from Athletics to KSUGCMRF that did not appear to be required by any lease agreement; (2) KSUGCMRF's relationship to the Foundation; (3) Mr. Krause's involvement as the Assistant Treasurer of KSUGCMRF with check-writing authority; (4) tax treatment for golf course bridge loan repayments, including payments by Mr. Krause; and (5) the accounting and financial controls for KSUGCMRF expenditures.

(1) We determined that there is no contractual obligation for Athletics to pay $20,000 per year. We recommend Athletics and KSUGCMRF examine the current agreements and structure and make a determination regarding future payments.

(2) KSUGCMRF is currently a subsidiary of the KSU Foundation. We recommend that the Foundation continue to review whether KSUGCMRF should be a wholly-separate entity.

(3) Mr. Krause is no longer an officer of KSUGCMRF.

(4) KSUGCMRF's debt is no longer on its balance sheet entitled, "Non-Recourse Line of Credit." It has been taken off the balance sheet as of June 30, 2009, and the bridge loans have been repaid by all of the guarantors. These loans were not on the books of KSUGCMRF until Mr. Krause requested that they be placed there in 2005. The Foundation sought guidance from its auditors before allowing these payments to be considered charitable deductions. We recommend that all contributions should be made within IRS rules, and the Foundation and KSUGCMRF may want to seek further opinions.

(5) KSUGCMRF has responded to the Grant Thornton report on its own, and has pledged to use stronger financial controls, including a detailed check request form for all expense payments.

Foundation Accounts

The Grant Thornton report identified several transactions that it criticized upon its review of the discretionary spending accounts provided to the Office of the President and the Vice President for Institutional Advancement.

By way of background, the Foundation supplies an Accounting Policy Manual for use by these offices to ensure proper documentation of expenditures. Both the Foundation and the University administration believe that these policies are adequate if followed. The Foundation began requiring submission of original receipts more than a year ago.

The Foundation does not make a value judgment about the propriety of the expenditure, only that it is properly documented. The Foundation believes that expenditures should meet the "light of day" test, meaning that the expenditures should withstand critical scrutiny if reviewed by the public.

Our summary of facts regarding individual transactions discussed in the Grant Thornton report is as follows:

One transaction involved a vehicle for a staff member. The staff member is Sue Peterson, Director of Governmental Relations, who is required to travel extensively as part of her position. The vehicle payment to Ms. Peterson from the Foundation account has been discontinued and that part of her compensation has been moved to salary.

One transaction involved a trip for Kerry Wefald, Jon and Ruth Ann Wefald's daughter-in-law, to New York. Amounts paid by the Foundation for this trip have been reimbursed in full by the Wefalds.

Some transactions involved payments to RB Enterprises, Inc. RB Enterprises is the vehicle leasing arm of Briggs Automotive Group. These payments were made for the leases on President and Mrs. Wefald's vehicles.

One transaction involved a double payment to the Manhattan Country Club. The double payment was discovered by Shelly Broccolo in the President's office approximately one week after it was made. After bringing the double payment to the attention of the Foundation, the Foundation and Manhattan Country Club agreed to apply a credit to Sue Peterson's country club account for future University-related business. Dr. Reagan told us that these facts were brought to Grant Thornton's attention, but they were omitted from the report.

One transaction involved a double payment of $107.51 to Wal-Mart. That double payment was discovered and resolved within a month of it occurring. Again, this fact was brought to Grant Thornton's attention but was omitted from the report.

Several transactions involved dinners given by Mr. Krause related to the Nutri-Joy/Coca-Cola transaction. We strongly encourage the Foundation to review the purpose of these dinners,

and, if appropriate, seek reimbursement from Nutri-Joy. Based upon our information, any benefit to the University was hypothetical, and at best, indirect and incidental compared to the direct benefit received by Nutri-Joy and its stockholders.

Scholarship Deficit

The Grant Thornton report also noted that a $2.4 million scholarship deficit became an issue during the 2007-2008 academic year.

In past practice, scholarship allocations began taking shape in early summer, when the University would estimate how much it might need from the Foundation. The Foundation would pay that estimate in late summer, and the entities would work together to "realign" the scholarship allocations. There was no mechanism to prevent the University from awarding more scholarship money than available from the Foundation, nor was there a mechanism to prevent the Foundation from paying more than the original estimate. By the 2007-2008 academic year, the amounts awarded by the University exceeded the Foundation's capabilities by $2.4 million total.

The $2.4 million debt does not appear to result from a single year's misestimation, as alleged by Mr. Krause to Grant Thornton. Instead, it appears that the deficit accumulated over the course of several years. We reached this conclusion based on the data provided by Dr. Bosco, who informed us that the yield percentage (the percentage of scholarships compared to those offered) in 2007-2008 only increased by 2 percent, including increasing the number of Putnam Scholars from 81 to 115 that year. Putnam Scholars received $6,000 for that academic year, resulting in an increase of only $204,000.

Moreover, the total scholarship amount allocated by the Dean of Student Life is only around $5 million per year, which means that the yield percentage increase would need to approach 50 percent without other significant factors. We did not learn of any other factors that could cause such a dramatic overage.

The Foundation brought the overage to the University's attention in 2008, and asked the University to repay it. The University agreed to repay the debt from several sources, including from license plate fees, logo royalties, the Pepsi contract funds, and discretionary funds from the Offices of the President and the Vice-President for Institutional Advancement. Some of these funds were to move through Athletics accounts. University administration believed that this repayment structure was appropriate and necessary under the circumstances.

In recent months, staff members from the University, the KSU Foundation, and the Alumni Association have devised a modified plan to repay the debt. The debt as of June 30, 2009 was $1.544 million. One million dollars will be repaid during FY 2010 – $190,000 from an unrestricted foundation account balance (beverage guarantee), $200,000 from the K-State Logo Royalty Program, $100,000 from beverage commissions, $400,000 from beverage guarantees that are held at the Foundation (traditionally used for dependent scholarships – that amount will be replaced with central funds within the University to ensure no impact on the dependent scholarship program), $110,000 from an emergency loan reserve (sufficient funds remain to

ensure no impact on the emergency loan program). The $544,000 deficit that remains as of June 30, 2010 will be repaid using $200,000 from the K-State Logo Royalty Program and approximately $350,000 from beverage guarantees that are held at the Foundation (traditionally used for dependent scholarships – that amount will be replaced with central funds within the University to ensure no impact on the dependent scholarship program). None of these funds will move through Athletics accounts.

Because of this debt issue, the Foundation has discontinued the practice of paying scholarship funds to the University and "realigning" those scholarships during the school year. Now, the Foundation requires that the University align and confirm scholarship funds before making payments. Communication between the University and the Foundation has increased to avoid future issues.

NISTAC Cluster

NISTAC Structure

The National Institute for Strategic Technology Acquisition and Commercialization ("NISTAC"), a 501(c)(3) not-for-profit corporation, was formed in 1994 (originally named the Mid-America Commercialization Corporation) as a partnership between the Kansas Technology Enterprise Corporation ("KTEC"), the City of Manhattan, and Kansas State University. The purpose of NISTAC is to facilitate the licensing and commercialization of intellectual property owned by the University and owned by other entities, including NISTAC itself. NISTAC has two for-profit subsidiary companies, Mid-America Technology Management ("MTM") and Manhattan Holdings ("MH"). MTM provides management and consulting services to NISTAC and NISTAC's startup companies. MH provides seed capital for the start-up companies that NISTAC is advising. MH is a partnership between KTEC, the City of Manhattan, and the KSU Foundation.

The University's Relationships with NISTAC

The University has several relationships with NISTAC. The Kansas State University Research Foundation ("KSURF") uses NISTAC as its licensing agent for all of its intellectual property. Operating documents from KSURF indicate that 10 percent of all licensing revenue is to be paid to NISTAC as compensation for its work. KSURF also uses NISTAC as its agent for the commercialization of its intellectual property. This relationship is much more informal than the licensing arrangement that KSURF has with NISTAC. Compensation arrangements between NISTAC and KSURF regarding commercialization activities appear to be done on a case-by-case basis.

The University directly supports NISTAC through an annual transfer of funds. Last year the University transferred approximately $500,000 to NISTAC, and similar transfers have been made annually. These funds are different from, and separate of, any compensation due to NISTAC from KSURF for its licensing and commercialization work. We strongly recommend that the University review this expenditure.

Protecting the University's Interests

Licensing and Commercialization

The licensing arrangement between KSURF and NISTAC is straightforward and transparent. NISTAC provides KSURF with assistance in licensing intellectual property and the KSURF gives NISTAC 10 percent of those licensing revenues. But there is no formal arrangement between KSURF and NISTAC regarding the commercialization of intellectual property. Therefore, it is difficult to assess how the University will be able to protect its interests. The University does have representation on NISTAC's Board of Directors. Thus, presumably, those individuals could protect KSURF's commercialization interests. If the University's interests are to be protected, the individuals representing the University and the University's senior administration should not have any personal economic interest in NISTAC or any of its start-up companies.

Nutri-Joy/Transparency/Conflicts of Interest

No University intellectual property was involved in the Nutri-Joy transaction. The University's interest in Nutri-Joy came from an equity investment made by KSURF in Nutri-Joy. That equity investment was not subordinated as a result of the Nutri-Joy deal with Coca-Cola.

The law firm of Wildman Harrold concluded that NISTAC's structure is legal and complies with all relevant regulatory guidelines. But this does not imply that this structure is sufficiently transparent for the University's interests to be protected. The Committee believes that the operating structure of NISTAC seems inordinately complex.

NISTAC does have a conflict of interest policy and that policy has been deemed as adequate by the law firm of Wildman Harrold. There were some documentation deficiencies that arose during the Nutri-Joy transaction but there did not appear to be any violations of NISTAC's conflict of interest policy.

From the University's perspective, the concerning conflicts of interest at NISTAC were those involving Dr. Wefald and Mr. Krause. Both individuals had ownership interests in Nutri-Joy and Bob Krause was on NISTAC's board, presumably representing the University's interests. Krause was also employed by NISTAC on a part-time basis.

The law firm of Wildman Harrold contends that it is legally appropriate for a member of NISTAC's board to have an ownership interest in an investee company. But the University needs to address whether it is appropriate for those representing its interests in NISTAC to have an ownership interest in an investee company. Also, the University needs to address whether it is appropriate for any senior administrator to have a personal economic interest in NISTAC or any NISTAC investee company, given the University's interests in NISTAC. It seems that either situation could create an actual or apparent conflict that could jeopardize the University's best interests.

Compensation Issues

All of NISTAC's employees are "leased" from its for-profit subsidiary company, MTM. There are caps placed on the amount of compensation that an MTM employee can receive. Those payments are capped based on an employee's base salary. It is unclear, however, whether this cap applies to equity-based incentive compensation given to MTM employees. Given that the University provides direct funding to NISTAC, bonuses paid to MTM employees are of concern. Clearly, NISTAC is reliant on funding from the University to continue its operations. Thus, we question the practice of paying bonuses to NISTAC (MTM) employees when NISTAC is not an economically viable concern. We recommend that the University ask for accountability in these bonus payments as long as the University provides direct funding to NISTAC.

Bob Krause did receive compensation payments from NISTAC for his work at NISTAC. His time at the University was to be reduced to reflect his external work with NISTAC. It does appear, however, that Bob Krause was to work 15 percent of his time at NISTAC, while his University time was reduced to only 90 percent. Thus, Krause received pay for 105 percent of his time. This is not a NISTAC issue but a governance issue for the University. The University had the right to refuse Krause's release time or ensure that he adequately reduced his University time commitment. The University chose to release Krause, did not properly reduce his University time, and subsequently overpaid him.

Athletics

Before this Committee began reviewing the issues in the Grant Thornton report, the Department of Athletics ("Athletics") had engaged the auditing firm of Deloitte & Touche, LLP to conduct an internal process control review of its operations. That review has taken several months, and we understand that Athletics intends to release that report in conjunction with this Committee's report. Deloitte reviewed internal processes related to contract administration, expense report and disbursement processing, and Imprest Fund administration review. Deloitte also examined the documentation for 13 transactions referenced in the Grant Thornton report and has confirmed that all of the transactions had documentation, approvals, or were corroborated through inspection of related contracts.

Our separate review of the facts indicated that Athletics has gone through significant changes in the last 12 months, even before the Grant Thornton report was released. Beginning in January 2009, Athletics began looking to improve its structure to bring it into better compliance with new IRS Form 990 requirements. The result was a restructuring of Athletics as a business entity, placing more decision-making responsibility in the hands of the Board of Directors, rather than centering that responsibility in one or two people. The new Board of Directors includes the Athletic Director (chair), a President's representative who must be a senior administrator, a similar Provost's representative, the University's Vice President for Administration and Finance (secretary/treasurer), the Vice President of Student Life, and the Faculty Representative to the Big 12 Conference. Each of the Board members is a University employee.

This structure requires the Board of Directors to approve any contracts that exceed $100,000 or that create obligations lasting longer than one year. All compensation for head coaches must be approved by the Board of Directors.

The new Board of Directors also adopted a new Imprest Fund policy, limiting expenditures to $5,000 per transaction. The Imprest Fund had been used by Athletics to make expedited payments outside of the University Controller's Office, usually for team and staff travel on an expedited basis. The Imprest Fund has been used on a limited basis since September. The University Controller will review monthly reconciliations.

Other new financial controls include:

- Both the Athletic Director and the Vice President for Administration and Finance must sign off on all expenditures of $50,000 or more;
- Athletic Director will personally review and approve all departmental expenses for the foreseeable future;
- Athletic Director's personal business expenses will be reviewed and signed off on by the Vice President for Administration and Finance; and
- A compensation committee to make recommendations and decide on employee compensation issues.

While we believe it is important to note this new Athletics structure, we discuss the individual Athletics issues raised in the Grant Thornton report below.

The Grant Thornton report identified several tax-related issues, including whether payments needed more employee/independent contractor analysis, whether an informal deferred compensation arrangement was appropriate, and whether there are tax-implications by making payments to former Athletic Director Tim Weiser. The University has sought independent legal and accounting advice regarding these transactions as recommended by Grant Thornton. Those consultations are privileged, but we understand that the University's Office of General Counsel is very comfortable with the evaluation.

Athletics follows the University's records retention policy, under which documents relating to financial transactions are destroyed after five years. Thus, the destruction of financial records older than five years was appropriate.

Mr. Krause received overload payments from 2003 through 2008, purportedly for his work in Athletics. Dr. Wefald wrote an explanatory letter in February 2009 that established his justification for the overload payments. People can disagree about whether these overload payments were appropriate. But any overloads, particularly for significant amounts and not paid through the University payroll system, must have significant justification and scrutiny, rather than becoming a yearly salary enhancement. It bears further mention that Mr. Krause received significant salaries during these time frames, and elected to reduce his time-commitment to the University in favor receiving payments from NISTAC. The University, and Dr. Wefald in particular, failed to ensure that Mr. Krause's total employment commitment was appropriately

distributed, because the total appointment between the University and NISTAC exceeded 100 percent.

Moreover, it seems to make little sense to allow a full-time employee to decrease his commitment to the University in favor of another entity, and then give that employee an overload payment to seemingly make up the difference.

Another issue is a loan to Tim Weiser of $500,000. The prior by-laws of Athletics allowed such loans. The new by-laws do not authorize loans.

A further issue relates to a potential double payment by Athletics toward a $100,000 Colbert Hills Founders Club membership for Coach Bill Snyder. Our review showed that KSUGCMRF was paid $87,500 for Coach Snyder's Founders Club membership as of 2006. Coach Snyder understood that payments to KSUGCMRF were to be made by Athletics after deducting the amounts from his salary, and there is documentation to support this practice. A disagreement arose between Coach Snyder and KSUGCMRF as to whether the full amount had been paid. To resolve the disagreement, Bob Krause authorized a $12,500 payment to KSUGCMRF in 2008.

A final issue relates to Coach Snyder's current contract, which was signed on September 11, 2009. The Grant Thornton report recommended that this contract be subjected to appropriate accounting and tax review. That review was done before the contract was executed by Athletics and the University on September 11, 2009.

Conclusion

In addition to the specific recommendations made in this report, we reach the following general conclusions:

First, it is apparent to us that Jon Wefald invested too much power in Bob Krause and provided inadequate oversight and supervision of him. Additionally, Dr. Wefald did not place adequate checks and balances on financial controls, allowing Mr. Krause far too much influence over a variety of University-related funds. Mr. Krause treated these funds as one pool of money, which created a variety of accounting and governance issues. The University needs to ensure that there is appropriate oversight of University funds and that there are reasonable checks and balances in place, so that University administrators act in the University's best interests.

Second, we have concerns regarding the scholarship deficit that accrued over several years. We were unable to assign specific blame for this oversight. But we believe that this deficit resulted from a lack of communication between University administration and the Foundation. Moving forward, better communication between the University and the Foundation is critical. For the University to be successful, University administration and the Foundation must work in concert. As part of this process, we suggest that the Foundation and the University work to reduce the scholarship deficit's burden on the University.

Third, we have general concerns regarding the University's relationship with NISTAC, because NISTAC's overly complex structure clouds its benefits to the University. The benefits from NISTAC need to be better defined and communicated to the University and the public, so that they can evaluate NISTAC's overall utility.

Finally, we are encouraged by the current administration's approach to financial and decisional transparency. This is most apparent in Athletics, where the new corporate structure encourages strong oversight by University administrators and the new Athletic Director has adopted a new code of transparency and fiscal accountability. We hope that the University administration will continue to emphasize this transparency, because we believe that it will lead to appropriate decision-making in the institution's best interests.

For the Committee,

Dr. Brian Spooner, Chair