November 13, 2013

Dr. Sharon Mosher, Dean
The University of Texas at Austin
Jackson School of Geosciences
2225 Speedway, Stop C1160
Austin, TX 78712-1692

Dear Dr. Mosher:

We have completed our audit of the Geology Foundation’s management of the oil and gas interests it has received and continues to receive from the bequest of Mr. John A. Jackson’s estate. The detailed report is attached for your review.

We conducted our audit in accordance with the guidelines set forth in The Institute of Internal Auditors’ *International Standards for the Professional Practice of Internal Auditing*.

We will follow up on recommendations made in this report to determine their implementation status. This process will help to enhance accountability and ensure that audit recommendations are implemented in a timely manner.

We appreciate the assistance provided by the Geology Foundation at The University of Texas at Austin.

Sincerely,

[Signature]

J. Michael Peppers, CIA, CRMA, CPA, FACHE
Chief Audit Executive

cc: Francisco Cigarroa, M.D., Chancellor, UT System
Francie Frederick, J.D., General Counsel to The Board of Regents, UT System
Pedro Reyes, Ph.D., Executive Vice Chancellor for Academic Affairs, UT System
William Powers Jr., J.D., President, UT Austin
Mike Vandervort, Chief Audit Executive, UT Austin
Terry Newman, Assistant Dean for Financial Affairs, UT Austin
The University of Texas System Administration
John A. and Katherine G. Jackson School of Geosciences
Geology Foundation’s Jackson Estate Trust Minerals
Audit Report

November 2013

THE UNIVERSITY OF TEXAS SYSTEM AUDIT OFFICE
702 COLORADO STREET, CLB 3.100
AUSTIN, TX 78701
(512) 499-4390
OVERVIEW
On December 19, 2003, The University of Texas (UT) System Board of Regents (Board) waived Regents’ *Rules and Regulations* 70301, Section 8, to authorize UT Austin’s Geology Foundation (Foundation) to manage the oil and gas royalties received from the estate of Mr. John A. Jackson. The Foundation is an internal foundation of the UT System that was created in October 1953. As a condition of the waiver, the Board required that the Foundation develop procedures to assure appropriate oversight by the Board and the Chancellor of the expenditures by the Foundation of income from Mr. Jackson’s bequest. A condition of the waiver included periodic audits by the UT System Audit Office to ensure compliance with the Royalty Financial Management Procedures developed by the Foundation. According to these procedures, the frequency of the audits are to be determined based on the assessment of the risks associated with this operation relative to other audit risks of the University, but in any event, audits are to be conducted at a minimum of every three years. The UT System Audit Office conducted an audit during the summer of 2004 to establish that procedures are in place and being followed by assigned personnel. Since then, the UT System Audit Office has performed audits of the Foundation’s management of its mineral interests in Fiscal Year (FY) 2007 and FY 2010 and has completed an audit during the summer and fall of 2013—the subject of this report.

AUDIT OBJECTIVES
The objectives of this audit included evaluating the:
- Administration of ownership records;
- Receipt of oil and gas royalty payments;
- Controls to ensure reported production accurately reflects actual production; and
- Controls to ensure appropriate royalty interest payments have been received.

EXECUTIVE SUMMARY
The John A. and Katherine G. Jackson Endowed Fund (Jackson Fund) was created on June 15, 2001, as a permanent endowment for the Foundation at UT Austin to support the John A. and Katherine G. Jackson School of Geosciences (Jackson School). Mr. Jackson confirmed his intent to commit 95 percent of his residuary estate to the Jackson Fund on February 27, 2002. The John A. and Katherine G. Jackson Estate (Jackson Estate) was transferred to the Foundation after Mr. Jackson passed away on March 21, 2003. At that time, the gift was valued in excess of $250 million—the largest single gift in UT Austin history. Approximately $84 million of the original bequest was based upon the valuation of the oil and gas mineral interests. As of August 31, 2013, the estimated value of the mineral interests is $92.7 million. The interests in minerals conveyed include overriding royalty interests, as well as a few working interests, from oil and gas properties. Currently, 28 operators produce oil and gas from approximately 1,300 wells. Most are gas wells located in Wise County, Texas.

From the procedures we performed, we found that the Foundation is adequately administering its ownership records, and there are adequate controls surrounding the receipt of royalty payments. Additionally, the Foundation has implemented controls to ensure the reported production is reasonably accurate and that royalty payments received are based upon values that are reasonably accurate. However, opportunities exist to enhance internal controls by updating internal process documentation, most of which has not been updated in several years and some of which included dated information and does not currently reflect existing practices. Opportunities also exist to strengthen controls over the cash handling processes by ensuring timely deposits of royalty payments, limiting access to a safe used to store checks, and ensuring all employees involved in cash handling receive the appropriate training. The Foundation can improve its monitoring of severance taxes withheld by operators by retaining its tracking spreadsheets in accordance with University documentation retention requirements and
clearly documenting the resolution of tax issues. The Foundation can also enhance its existing gross value reconciliation, production reconciliation, and decimal reconciliation procedures by modifying how the largest producers are selected for review, tracking which properties are selected for testing, and clearly documenting the resolution of exceptions.

**SCOPE AND METHODOLOGY**
Our audit of the Foundation’s management of its royalty interests covered the period from September 1, 2011 through August 31, 2013. We conducted our audit in accordance with the guidelines set forth in The Institute of Internal Auditors’ *International Standards for the Professional Practice of Internal Auditing*.

To meet our objectives, we reviewed existing policies and procedures; interviewed Foundation staff; reviewed and tested the cash handling and reconciliation processes; selected and tested a sample of new wells added to the Foundation’s portfolio of mineral interests; selected and tested a sample of 30 royalty payments emphasizing the highest producing properties; and conducted other procedures deemed necessary for this audit.

**CRITERIA**
- UTS166 – *Cash Management and Cash Handling Policy*
- UT Austin’s Handbook of Business Procedures

**CONCLUSION**
The Foundation is adequately administering its ownership records, and there are adequate controls surrounding the receipt of royalty payments. Additionally, the Foundation has implemented controls to ensure the reported production is reasonably accurate and the royalty payments received are based upon volumes and values that are reasonably accurate. The Foundation also has processes and procedures to manage its mineral interests and provide assurance that the royalties it receives are reasonably accurate; however, most of these processes and procedures have not been updated in several years and need to be revised to reflect current activities. Other opportunities also exist to enhance existing controls related to cash handling, monitoring of severance taxes held, and reconciliations.

---

J. Michael Peppers, CPA, CIA, CRMA, FACHE  
Chief Audit Executive

Eric J. Polonski, CPA, CIA 
Assistant Director
BACKGROUND
The Foundation is an internal foundation of UT Austin that was created in October 1953. The Foundation supports the Jackson School. Created on June 15, 2001, the Jackson Fund is a permanent endowment established to support the Jackson School. On February 27, 2002, Mr. Jackson confirmed his intent to commit 95 percent of his residuary estate to the Jackson Fund, which is administered by the Foundation at UT Austin. The transfer of the Jackson Estate to the Foundation was initiated after Mr. Jackson passed away on March 21, 2003 and was valued in excess of $250 million.

The endowment includes overriding royalty interests, as well as a few working interests, from oil and gas properties. The mineral interests are derived from wells covering 177,000 acres located primarily in Wise County, Texas. Currently, 28 operators produce oil and gas from roughly 1,300 paying wells. As illustrated in the chart to the right, the Foundation has received over $20 million in royalty payments from September 2009 to August 2013. Most of the royalties are based on natural gas sales. Devon Energy Corporation (Devon) is the largest operator, accounting for more than 85 percent of royalty payments.

RESULTS
Ownership Records
There have been 51 new wells added since September 1, 2011. Once a new well has been drilled and completed and starts producing, the operator will send a division order to the Foundation. A division order is a revocable document that provides the source for determining the basis of payment to be received. It indicates the ownership of the Foundation’s decimal interest in proceeds from the property. The Foundation inputs the decimal interest shown on the division order into a database. The database is the key resource the Foundation uses to monitor and track lease activity. We selected a sample of new wells and verified that division orders were obtained and appropriately executed. Since the decimal interest is used to calculate the royalties due to the Foundation, we tested a sample of new properties and verified that the royalty interest percentages recorded in the database agreed to the executed division order without exception.

Payment Process and Transfer Process
The Foundation receives wire transfers and checks for royalty payments. Over 85 percent of the royalty receipts are from wire transfers. Both check and wire transfers are recorded in the database and deposited with UT Austin’s Bursar Services. The Foundation reconciles monthly amounts it records in the database to amounts recorded in the Foundation’s *DEFINE accounts. After deposit, the entire amount is transferred from UT Austin to The University of Texas Investment Management Company (UTIMCO). In accordance with the Uniform Principal and Income Act, an equitable portion of the royalty payment must be retained as principal in the endowment. Due to the complexity of calculating the required portion retained as principal, UTIMCO retains 25 percent in the endowment principal account and transfers 75 percent of the royalties received back to the Foundation. UTIMCO performs this transfer quarterly. We tested a sample of reconciliations and confirmed that the Foundation reconciles its royalties recorded in *DEFINE to the detail of royalty deposits recorded by UTIMCO, to the Foundation’s check log, and to amounts recorded in the Foundation’s database. In addition, the
Foundation reconciles the quarterly transfers it receives from UTIMCO as recorded by UTIMCO to the quarterly transfers recorded in *DEFINE.

We also compared the total royalty deposits and transfers as recorded in *DEFINE to amounts recorded by UTIMCO. We found that the total royalty deposits and transfers recorded in *DEFINE materially agreed to the amounts recorded by UTIMCO. We also compared amounts recorded as transfers from UTIMCO’s records to transfers recorded in *DEFINE. We found that the transfers recorded by UTIMCO agreed to the distributions recorded in *DEFINE. Lastly, we compared the amounts reinvested by UTIMCO, as recorded in UTIMCO’s records, to amounts recorded as received by UTIMCO. We determined that UTIMCO reinvested 25 percent of the royalties received in compliance with the Royalty Financial Management Procedures. Inmaterial differences are due to timing differences of when transactions are recorded in *DEFINE, the Foundation’s database, and by UTIMCO.

**Volumes and Royalties Recalculation**
The operators' payments are accompanied by comprehensive check stubs. The check stubs detail the volumes sold, commodity pricing, gross values, taxes and deductions, and the royalty decimal interest. To determine whether reported sales reflected actual sales, we compared volumes on check stubs for 30 payments from among 24 of the highest producing properties to volumes reported by the operators, to the Texas Railroad Commission (RRC) and to the Texas State Comptroller (Comptroller). The volumes recorded in the database materially agreed to the volumes reported to the RRC and Comptroller. Using the check stubs and division orders, we recalculated the royalty due to the Foundation for 30 royalty payments from among 24 of the highest producing properties. Lastly, we verified that the decimal interest agreed to the decimal interest recorded in the executed division orders. No material exceptions were noted; however, severance taxes were deducted from the royalty payments for four of the properties tested. Further discussion of severance taxes is described on page six of this report.

**Procedures**
The Foundation has developed and documented comprehensive Royalty Financial Management Procedures that provide instructions for management of its mineral interests and royalty payments. These procedures describe processes to manage the legal documents concerning ownership and royalty rights and to account for receipt and deposit of payments. In addition, the Foundation has developed a standard periodic process for analyzing new well activity, production, prices, taxes withheld, and gross value to ensure appropriate royalties are being received. The Foundation’s efforts in managing the mineral interest and royalty payments are commendable. However, the majority of the Geology Foundation’s procedures have not been updated in several years. Some of the procedures include outdated information and do not consistently reflect current practices.

**Recommendation:** The Foundation should periodically review and, as necessary, update information and the procedures to accurately reflect current practices.

**Management’s Response:** We will update our procedures to make sure they include our current organizational structure and practices. We will review our procedures every year, but if a major change occurs, procedures will be revised without delay.

**Implementation Date:** January 31, 2014

**Check Handling Process**
During FY 2013, the Foundation received just over $385,000 in royalty payments each month by check or by wire transfer. Except in a few instances, Devon and Stephen & Johnson Operating Company send their royalty payments by wire transfer. The remaining operators send royalty payments by check. Almost 15 percent of the
royalty receipts are from checks. The Office of the Dean receives checks for royalties, gifts, and sometimes checks for the Jackson School. On average, the Foundation receives approximately 30 checks per month and most are for oil and gas royalty interest payments.

Deposits
UTS166, Cash Management and Cash Handling Policy (UTS166), requires that all receipts totaling $500 or more be deposited within the next business day or deposited biweekly for departments that do not collect revenue each day. We tested a sample of 17 checks received, which ranged in value from $3,500 to $71,000. We noted 10 instances (59 percent) in which checks were not deposited timely with UT Austin’s Bursars Services in accordance with UTS166. We also noted four checks (24 percent) were not dated with a departmental date stamp.

Safes
Royalty payments received by check are stored in a safe when not immediately deposited. Currently, three student assistants, an accounting supervisor, an administrative assistant, and an executive assistant, have the code to the safe where the checks are stored while waiting to be deposited. In addition, other items, such as department procurement cards are stored with the checks. According to UTS166, “combinations or keys for cash receptacles shall be maintained only by designated custodians and supervisors.” To ensure that the Foundation’s assets are adequately safeguarded, access to the safe should be limited.

Training
According to UT Austin’s Handbook of Business Procedures, Part 6.1.B., Cash Handling, “[each] chair or head of a department, office, or laboratory that accepts cash or checks for any purpose is responsible for assuring that proper procedures for handling and accounting for cash are followed. Cash handling requires special control measures... Employees who handle cash are required to complete CW 505 — Cashier Training.” We found that all individuals involved in the collection process as of August 15, 2013 had taken CW 505 — Cashier Training except for one student assistant.

Recommendation: The Foundation should:
- Ensure the timely deposit of oil and gas royalties in accordance with UTS166.
- Ensure all checks are stamped with the date received.
- Limit access to the safe to only the designated custodians and supervisors and, as part of limiting access, consider alternatives for adequately safeguarding other assets that may not need to be stored within a safe.
- Ensure that all employees who handle cash or checks complete CW 505 — Cashier Training before handling cash or checks.

Management’s Response: The Financial Affairs staff of the Foundation has reviewed and implemented new procedures to ensure timely and secure processing of check handling for royalty payments. The Accounting Supervisor will oversee this process on a daily basis while the Financial Affairs-Administrative Manager has oversight of check handling process and acts as back-up for the Accounting Supervisor in his absence. The Accounting Supervisor will ensure that the full-time front desk assistant or any employee who handles cash or checks complete Cashier Training (CW505) before handling cash or checks and that all checks are stamped with the date received. All royalty payments will be kept separate from all other deposits in a secure location and stored in a safe. As of November 7th, 2013 a safe has been purchased and placed in the Accounting Supervisor's office; the office is kept locked when not occupied. Access to the aforementioned office is limited to Dean’s management while access to the safe is limited to the Foundation’s Financial Affairs staff, which includes the Assistant Dean for Financial Affairs, Financial Affairs Administrative Manager and Accounting Supervisor; all of whom are directly involved in the deposit process and/or have oversight of the deposit process.
Implementation Date: November 8, 2013. [Auditor’s Note: Prior to report issuance, the UT System Audit Office verified that management has a separate safe, which only stores royalty interest checks; that access to the safe is limited to the Assistant Dean for Financial Affairs, the Accounting Supervisor, and the Administrative Manager; and that all employees who handle cash or checks have taken the appropriate training. We will follow up on the new process to ensure timely and secure processing of checks for royalty payments at a later date.]

**Taxes**
The Foundation, as part of UT Austin, is tax-exempt, and operators paying royalty income to the Foundation should not deduct severance taxes from their royalty payments. Each year, the Foundation tracks severance taxes deducted from royalty payments. The Internal Revenue Service Form 1099-MISC (1099 form) is necessary to perform this procedure as it can indicate whether state taxes have been withheld from royalty payments. The Foundation compares taxes withheld from the 1099 forms to taxes recorded from the check stubs in the Foundation database. To perform the tax reconciliation procedure, all 1099 forms are needed from the operators; however, each operator did not provide the 1099 form requested by the Foundation. Using this process, the Foundation has identified and recovered underpayments of oil and gas royalty due.

The Foundation uses a spreadsheet to track which operators withheld taxes and actions taken by the Foundation to resolve identified exceptions. We requested the tracking spreadsheets for 2010, 2011, and 2012. The Foundation was unable to locate the tracking spreadsheet for 2011, and the disposition of all items for 2010 and 2012 was not clearly documented. We also tested three potential tax issues from three different operators. The Foundation had not yet requested a refund from one operator, and the disposition of certain deductions from a second operator was not known. For the third, the Foundation stated that the operator had been unresponsive to the Foundation’s requests.

As previously mentioned, we tested 30 royalty payments from among 24 of the highest paying properties. It appears that the operators are paying based upon the correct volume and value; however, severance taxes were deducted from the royalty payments for four of the properties tested. The Foundation has been reimbursed for one of the properties; however, the Foundation has not been reimbursed for the remaining three. Lastly, we reviewed royalty payment history from the Foundation’s database for five new wells added since September 1, 2011. There were two properties in which taxes were deducted from the royalty payment and additional royalty may be due.

**Recommendation:** The Foundation should obtain all 1099 forms from all operators that pay royalty interest, retain its tax tracking spreadsheets in accordance with UT Austin’s document retention requirements, and ensure that the resolution of the withheld taxes is clearly documented. The Foundation should also consider documenting the resolution of the withheld taxes as recorded in its database. Lastly, the Foundation should request reimbursement for the additional royalty due from the audited properties in which taxes were withheld from the royalty payments.

**Management’s Response:** We will make sure that all the 1099 forms are received in order to reconcile taxes for a particular year. We will update our spreadsheet reconciliation yearly and we will contact the operators (letters) to request the corresponding refund. We will keep record of our communication with operators regarding this issue and will make sure we document the resolution of taxes withheld. We will consider potential escalation for unresolved issues. In general, we will request the refund for the total charged by the operator in a particular year, and in particular we will request refunds of the specific leases audited where taxes were charged.
Implementation Date: March 31, 2014 (1099 forms for the tax year 2013 will be received between January and March 2014)

Reconciliations
The Foundation performs a variety of reconciliations for a sample of properties to ensure the accuracy of royalty payments. These include quarterly gross value reconciliations, an analysis of the gross value of sales as reported by the operator to the gross value reported by the operators to the Comptroller; decimal reconciliations, an analysis of royalty interest percentages as reported on check stubs to the relevant division orders; and production reconciliations. While these processes are valuable monitoring tools, opportunities exist to strengthen them.

Recommendation: The Foundation should consider incorporating the following to enhance the existing processes as described below:
- Track properties previously tested to ensure that previously tested properties are not unnecessarily re-tested and to ensure that more properties are reviewed.
- For the decimal reconciliation process and production reconciliation process, the Foundation analyzes the top 10 properties that have the highest cumulative payment received by the Foundation since the transfer of the Jackson Estate. The drawback of using a cumulative payment approach is that it results in the same properties being examined from year to year.
  - The production reconciliation process would be improved by selecting the top 10 properties that have the highest payment for a selected year.
  - The decimal reconciliation process could also be improved by incorporating a sample of new wells as part of this monitoring process. Incorporating new wells can help ensure that any payment errors are detected timely and not repeated.
- Lastly, the Foundation has incorporated a comment field that clearly shows how exceptions are handled for the decimal reconciliation and the non-paying well reconciliation. The Foundation should consider enhancing the gross value reconciliation and the production reconciliation process by incorporating a comment field that shows the disposition of exceptions from properties reviewed.

Management’s Response: For the Gross Value Reconciliation, we have created a spreadsheet with the properties reviewed within the last 12 months and will update it with new wells selected for the reports to make sure the same properties are not selected. We will modify the database query for the production reconciliation in order to select the top 10 properties for the last year. The decimal reconciliation will include an additional sample of 10 properties selected randomly, and we will keep a record (spreadsheet) to make sure we don’t repeat the sample. We will update the reports to include the comment field to show how the reconciliation differences are being investigated.

Implementation Date: January 31, 2014