The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
November 18, 2009

The Committee on Compliance and Audit met on the above date at Covel Commons, Los Angeles campus.

Members present:	Regents Bernal, De La Peña, Makarechian, Ruiz, Stovitz, Varner, and Zettel; Advisory members Hime and Simmons
In attendance:	Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, Chief Compliance and Audit Officer Vacca, Executive Vice President Taylor, and Recording Secretary Johns

The meeting convened at 4:35 p.m. with Committee Chair Ruiz presiding.

ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2009

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

PricewaterhouseCoopers (PwC) representative Joan Murphy informed the Committee that, as the external auditors for UC, PwC is required to communicate certain items to the Committee, to provide a sense of how an audit progresses and to assist the Committee in fulfilling its oversight role. PwC issues an opinion on the University's consolidated financial statements, including the ten campuses, the five medical centers, and Lawrence Berkeley National Laboratory (LBNL). PwC issues an opinion on the UC Retirement System, the benefit plans, including the defined benefit and defined contribution plans, and the health and welfare plan. PwC issues five separate opinions for the five stand-alone sets of financial statements for the medical centers. PwC provides observations from Agreed Upon Procedures at LBNL, with a focus on internal controls related to external reporting. PwC will issue a report on the University's compliance with federal award programs, the A-133 audit, in early 2010. PwC also issues reports on National Collegiate Athletic Association (NCAA) Agreed Upon Procedures and on revenue bond indenture audited financial statements.

Ms. Murphy began with an overview of the Required Communications to The Regents' Committee on Compliance and Audit. She explained that the external audit is designed with the concept of materiality in mind. PwC does not examine 100 percent of transactions or 100 percent of account balances. The audit takes a risk-based approach and ensures enough coverage and testing to allow issuance of an opinion on the fairness of the financial statements. Ms. Murphy specified that the audit gives reasonable but not absolute assurance regarding detection of material fraud. PwC has been engaged to conduct the audit in accordance with generally accepted auditing standards and with government auditing standards; the latter are especially relevant to the A-133 audit on compliance with federal award programs.

During the past year, the University has implemented Governmental Accounting Standards Board (GASB) Statement 49, which concerns accounting for pollution remediation costs. Effectively, if the University knows that it will incur pollution remediation costs, it must now accrue these costs, including them on the balance sheet. The amount this year was not significant, about $49 million. What was of interest to the auditors was the question of how the University ensured that it defined the universe of exposure in this area. It is important that all possible liability in this area be identified, and that it be quantified correctly. PwC did not have any concerns about this topic.

All the University's accounting policies are disclosed in the footnotes to the financial statements. Ms. Murphy noted that a few are critical policies, some related to the medical centers. PwC representative Michael MacBryde explained that audits of the medical centers focus on areas that, from a risk perspective, employ the majority of the estimates, such as patient accounts receivable, revenue-related estimates, and estimates around third-party settlements. These areas present the most significant risk. PwC does a fair amount of work on third-party reserves and estimates and coordination with the business units. It examines the effectiveness of the estimate process in the previous year. PwC found that, at every UC medical center it examined, estimates were within a reasonable range. The estimates for the previous year were also reasonable. Current-year revenue did not provide any basis for significant change in prior estimates for accounts receivable.

Third-party settlements typically involve a governmental payer, Medicare or Medi-Cal. In these cases there can be a significant backlog, and the governmental payer can revise the amount of revenue earned by the University seven or eight years previously. There are significant estimates for the medical centers in this area, and these are complex, involving specific rules located in a variety of different regulations. PwC employs a specialist to assist with this part of the audit and coordinates its work with the Office of the President, because a fair amount of work on the Medi-Cal program, including modeling, is done centrally. The current-year profit and loss statements did not warrant significant changes to the modeling. The estimates were reasonably stated.

Ms. Murphy then explained that there are certain areas of the generally accepted accounting principles in which organizations have a choice of how to apply policies. She noted that Committee members might see this in differences between the financial statements of another organization and UC. The University applies all GASB pronouncements after November 1989. Prior to that, the University applied the Financial Accounting Standards Board (FASB) pronouncements. In regard to charging restricted versus unrestricted funds, in the private sector, donor-restricted gifts or grants for certain purposes in some cases must be spent first or reflected as spent first in financial statements. Under GASB, institutions can decide whether to spend unrestricted funds first or not. GASB rules are not as strict as FASB rules.

Perpetual trusts held by third parties are probably most important for individual foundations, which are included in the consolidated financial statements. In an external trust, an outside trustee holds investments that are ultimately for the benefit of the University. Some institutions record these on their balance sheets as a receivable, others do not.

The valuation of non-publicly traded investments is a challenge for UC and for any organization with a significant investment portfolio. The University uses methods for determining these values. In some cases, it does not have data available as of June 30 to report fair value, but there are means of estimating value. There are a variety of practices in this area.

There were no unusual transactions in 2009. Two new accounting pronouncements will become effective next year. One concerns the recording of derivatives in financial statements; the other concerns the recording of intangible assets, such as patents and royalties. Institutions which apply FASB pronouncements have been recording these for a number of years, but the pronouncements are new for GASB. The Office of the President has already been examining these pronouncements. The complexity of the University warrants a two-year lead-up period for accumulating the data needed for implementation.

Ms. Murphy then discussed estimates involved in the financial statements. Some figures in the University’s financial statements are easily verifiable by outside parties, such as cash and readily traded securities. Other items involve judgment. The University is self-insured for workers’ compensation and medical malpractice. It uses outside actuaries to help estimate reserves and costs, based on past experience. PwC also has internal actuaries who assist the audit team in evaluating the reasonableness of those reserves. Reserves for bad debts are another item that requires judgment. These reserves are for pledges, mortgages, and notes receivable. The reserves for bad debts on June 30, 2009 were $276 million. Mr. MacBryde noted that the $98 million listed in the reserves for medical center third-party payer settlements is a net number. There may be $200 million in liabilities and about $120 million in assets which result in the net amount.

Regent Makarechian asked about the amount of the University’s interest rate swaps, in conjunction with medical center pooled revenue bonds, which will have to be recorded according to the new GASB pronouncement on derivatives. Chief Financial Officer Taylor responded that the University currently has two swaps outstanding, one each for the UCLA and UC San Francisco medical centers. The University’s swap portfolio is small.

Regent Makarechian inquired about the basis for the estimated settlements with various third parties. Assistant Vice President Plotts responded that the rules which apply in dealings with Medicare or Medi-Cal are complex. Many years can remain open under audit. In some cases, the University may be reimbursed by Medicare or Medi-Cal, and years later, Medicare or Medi-Cal may seek reimbursement, claiming that the University has not applied a law correctly.

Regent Makarechian asked about the size of the reserves for medical center third-party payer settlements. Mr. Plotts responded that the University’s Medi-Cal revenue is in the range of $550 million to $600 million. The reserve amount is small relative to the University’s Medicare and Medi-Cal revenues.

Regent Makarechian referred to the estimate of the fair market value of mortgage loans, and asked if these are residential loans to faculty. Mr. Plotts responded in the affirmative. These loans are part of the University's Mortgage Origination Program (MOP). They are variable rate loans, and the fair value amount stated in the report is effectively the principal outstanding. Mr. Taylor added that the University has a reserve for these loans. An outside consultant was engaged to determine what the appropriate reserve amount would be if the University were a Federal Deposit Insurance Corporation (FDIC) lender. The consultant found that the reserve set aside for the MOP loans is more than adequate.

Ms. Murphy observed that this is probably the most complex area of external reporting, involving a great deal of judgment. Another such area is the investment portfolios of the University and its retirement plans. The bulk of these are readily traded securities, for which it is easy to determine fair market value. However, other parts of the portfolio are not readily traded, such as private equity, alternative investments, and hedge funds. Their fair market value is much more difficult to determine. The general partner of those partnerships provides a fair value to the University, and the Office of the Treasurer must examine these values for accuracy.

Regent Makarechian asked if the University, as a limited partner, would receive a callback in case of a liability. Ms. Murphy responded that this would depend on the partnership arrangement. The Office of the Treasurer would determine if there was a liability, and would communicate this to the Office of the President.

Ms. Murphy noted that PwC has an audit partner, a senior manager and a team with expertise in investments who carry out the audit work at the Office of the Treasurer. This is appropriate, given the complexity of the UC portfolio.

The University's total consolidated investments are about $13 billion. A small segment of these are non-agency mortgage-backed securities, which have stopped trading on a regular basis. In order to determine their fair value, in 2009 the University undertook internal modeling to anticipate cash flows and estimate the June 30, 2009 fair value. The University explained this action to PwC. When PwC developed its auditing procedures, it took a somewhat different approach. PwC made use of third-party pricing services for an estimate. This estimate was not based on any active trading. It was different from the University's estimate, but the difference is tolerable from an audit perspective.

In response to a question asked by Regent Makarechian, Mr. Taylor responded that these non-agency mortgage-backed securities are among the securities held in the UC Retirement Plan portfolio and other parts of the UC investment portfolio. They are not related to the mortgage loans to faculty.

Ms. Murphy returned to the difference between PwC's and the University's valuation of investments. This difference was about 0.31 percent of total investments on the consolidated financial statements and about 0.66 percent on the UC Retirement System total investments. These are small percentages, although large dollar amounts, given the size of the portfolio.

Ms. Murphy noted that the report contained information on interest rate swaps in late 2008 and early 2009, originally held with Lehman Brothers.

Ms. Murphy emphasized that, if PwC had identified any audit adjustments above a certain dollar amount that came about as the result of the audit, recorded or not recorded, she would be required to report them to the Committee. The report included a list of dollar amounts or thresholds for the various audits at which PwC would propose an adjustment. There were no proposed audit adjustments. Several prior-period or out-of-period adjustments were identified. During the 2009 fiscal year, items were discovered that should have been recorded differently in the 2008 financial statements. In that situation, it is the task of management to evaluate whether those errors would materially affect the 2008 financial statements and to determine if these financial statements were acceptable and reliable as presented. Management provides an evaluation, and this is reviewed by PwC. PwC was comfortable with the evaluation of the adjustments as not material. In general, the adjustments were corrected in 2009, or, if not significant, were not recorded. These adjustments were shown in an appendix to the report.

Ms. Murphy then discussed the significant risks and uncertainties faced by the University and what changes there might be to the financial statements, besides the estimates and reserves already mentioned. The University receives a substantial amount of federal awards. Any federal agency can audit compliance for a particular grant. If there were concerns about compliance or about the application of the indirect cost rate, the agency could request repayment. This is part of the nature of an arrangement with the federal government. No critical issues came to light as part of the PwC audit. Any exposure that there might be is not significant to the University's financial statements.

Another part of the Required Communications is to inform the Committee of any internal control deficiencies that have been discovered. PwC identified no significant deficiencies or material weaknesses. PwC has provided recommendations to the University for improvements in overall internal controls. Ms. Murphy observed that this was a year in which she expected some slippage in the internal control environment due to transition among employees and to the reduced workforce, but PwC did not encounter this. She commended UC management on this point.

PwC representative Jaime Jones provided comments on the Report to the Regents' Committee on Compliance and Audit for the Year Ended June 30, 2009. This is a report on internal controls over financial reporting, which PwC considers as part of its audit of the financial statements, but PwC does not issue an opinion on the internal controls. This report summarizes what PwC observed at all ten campuses. Each chancellor received a campus-specific report; this report discusses common themes. The report identified a control deficiency concerning the timeliness and documentation of certain control procedures. Ms. Jones emphasized that there were no misstatements identified as a result of any control deficiencies. Ms. Murphy added that this observation was in the nature of a housekeeping comment. PwC did not see any failure of controls; but it is important that controls are not only designed correctly and operate correctly, but that there is documented evidence that controls occur. The recommendation is that the University enhance the documentation of its reviews.

Ms. Jones noted that the report contained two further recommendations concerning information technology user access and monitoring. PwC did not identify any cases of unauthorized access in its detail testing, but there were instances in which a review was not documented as being performed. Ms. Murphy added that the audit is focused on financial statement information, not on all systems or all data. PwC found that there is generally a good degree of control for the protection and integrity of financial data, which ultimately become part of the financial statements. In some cases, and at several locations, there could be more rigorous review of who has access to which data, and of who has access to make changes to which data. PwC has observed progress on this issue in the last three years. There are manageable ways to ensure that an individual's access to data is revoked when his or her job responsibilities change and access is no longer needed.

The meeting adjourned at 5:00 p.m.

Attest:

Secretary and Chief of Staff