The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
November 12, 2013

The Committee on Compliance and Audit met on the above date at UCSF–Mission Bay Conference Center, San Francisco.

Members Present: Regents De La Peña, Feingold, Flores, Makarechian, Ruiz, Schultz, and Zettel; Advisory member Gilly; Staff Advisors Barton and Coyne; Expert Compliance Advisor Guyton

In attendance: Regents Napolitano and Newsom, Regents-designate Engelhorn and Leong Clancy, Faculty Representative Jacob, Secretary and Chief of Staff Kelman, Associate Secretary Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Provost Dorr, Executive Vice President Brostrom, Chief Financial Officer Taylor, Senior Vice President Stobo, Vice Presidents Lenz and Mara, Chancellors Katehi and Khosla, and Recording Secretary Johns

The meeting convened at 2:40 p.m. with Committee Chair Zettel presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of September 18, 2013 were approved.

2. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2013**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Associate Vice President and Systemwide Controller Peggy Arrivas drew attention to the fact that for the first time, there was a single, combined financial report in one book for the five medical centers. She recognized the work of her staff and the medical center controllers for accomplishing this. She remarked that the new UC Retirement Plan (UCRP) tier, with a new eligibility tier for health benefits, had an effect on the University's actuarial valuation, a decrease of $2 billion in post-employment benefit liabilities in the current year.

PricewaterhouseCoopers (PwC) representative Joan Murphy explained that in addition to opinions on the various financial statements, PwC provides two documents. The first, the Required Communications to The Regents' Committee on Compliance and Audit, provides an overall sense of the audit, audit results, information on any unusual transactions, and any significant changes in the financial statements. PwC did not identify any audit adjustments above set thresholds used for the various UC entities. PwC uses different thresholds depending on the size of the entities. PwC did not detect any fraud. PwC received the full cooperation of management and the institution in carrying out its audit.

The second document, the Report to The Regents' Committee on Compliance and Audit, includes internal control observations and recommendations. PwC's practice has been to report control deficiencies at multiple locations in this document, if such deficiencies are detected. PwC had two recommendations for the current year. The first pertained to logical security access controls, ensuring that appropriate personnel have access to data, and documentation of access. The second recommendation concerned segregation of duties. Preparation of the financial statements depends on journal entries, and auditors focus on whether there is any opportunity for individuals to create fraudulent journal entries. PwC found a range of different environments at the various UC locations, and the campuses and medical centers were very responsive to PwC's guidance in this matter prior to the year end. Overall, PwC found this to be an area of control deficiency at UC. At two locations, the deficiency rose to the more serious level of material weakness. These matters were taken seriously and had been addressed at the relevant locations prior to the calendar year end and audit year end.

Ms. Arrivas explained that PwC did not find any erroneous journal entries at the two medical centers concerned; the findings concerned procedures. At one of the locations, the situation has been corrected. At the other location, the situation was currently being addressed, and the corrective action would be reviewed by the Office of Ethics, Compliance and Audit Services before the end of the calendar year. PwC's findings had been taken seriously and acted upon.

Committee Chair Zettel expressed appreciation for the serious attention the University has given to matters raised by PwC.

Regent Ruiz referred to information included under "Significant or Unusual Transactions" in the Required Communications to The Regents' Committee on Compliance and Audit. The federal government had not paid the University $80 million of receivables. He asked what the University would do to resolve this. Ms. Arrivas responded that the obligation from the federal government was for retirees from Los Alamos National Laboratory (LANL) and Lawrence Livermore National Laboratory (LLNL) who retired at the time of the Laboratories' transition to an LLC structure. According to an agreement with the Department of Energy (DOE), the DOE would pay its liability for these retirees over seven years. The University calculates the amount owed by the DOE each year. The previous year, the DOE promised to pay UC $306 million, which was due in February. The DOE paid only $226 million due to federal budget sequestration. It is the University's understanding that the DOE has identified another funding source to pay the remaining $80 million. Payment depends on a number of internal DOE approvals, and four congressional committees must approve the payment to UC as well. Because the congressional approvals were still pending, UC determined that it was not appropriate to identify this amount as an asset in its financial statements until those approvals occur. Ms. Arrivas noted that the status of these approvals was being closely monitored by Vice President Mara. Mr. Mara added that because of the unusual state of the federal government and the need for congressional committee approvals, the University thought it necessary and appropriate to remind the DOE of its contractual obligation. He stated that the DOE had been responsive in recognizing this obligation and was operating in good faith, but that the slow pace of the process was disappointing. Mr. Mara seconded Ms. Arrivas' point that it would not be appropriate to report assets that were not yet received. Mr. Mara stressed that he did not expect a problem to arise in connection with this matter. There would be no short-term impact, but he described this as an unfortunate trend in the way the federal government was addressing its contractual responsibilities. Ms. Arrivas referred to the financial statements, which showed that the DOE portion of the liability was still funded over 80 percent. The University was not facing challenges in continuing to pay retirees' benefits. The significant issue was that the DOE was not complying with the contract signed with the University several years earlier on payment terms. Chief Financial Officer Taylor stated that the Office of the President would keep the Regents apprised as the process proceeded. Obviously, the University wishes to secure the monies it is owed by contract. If for some reason this did not occur, the Regents would be apprised and the matter would be raised to a higher level. Regent Ruiz concurred that this would be an appropriate action.

Regent Ruiz referred to PwC's comment on logical security access controls in the Report to The Regents' Committee on Compliance and Audit. He stated his view that the management response in the document had the appearance of a short-term solution, addressing issues as they arise. He expressed the desire for a long-term solution, and suggested that software programs might provide such a solution. Ms. Arrivas responded that the crucial issue in this area was granting access rights appropriately, the authority given to employees to carry out certain transactions; this could not be programmed. Control over access was at the discretion of management. The University corrected a number of these issues the previous year, is becoming more diligent in this area, and is examining how access will be assigned in new systems. As part of the new payroll system implementation, the University is seeking ways to manage this problem and avoid these findings when the system is implemented. The correction of this problem involved a change in organizational culture and in thinking about how access is granted.

Regent Ruiz asked if there were consequences for employees who do not understand the importance of these controls. Ms. Arrivas responded that there were currently no consequences; the University continues to focus attention on this area.

Regent Ruiz expressed the hope that there would be improvement over time. Ms. Arrivas responded that this is a difficult area in which to make improvements. This is a very common finding, brought up in almost every auditor's letter. She stressed that the University does make improvements every year.

Committee Chair Zettel asked Ms. Murphy if she had in fact seen improvement at UC over the years, and if the current audit had identified problems at the same locations as in the past. Ms. Murphy responded that those locations where PwC identified this issue the previous year addressed the issue seriously and responded appropriately. They were consistently able to document that access reviews were performed. The findings for this year's audit were in new locations. Some of these locations were undergoing other system implementations that drew resources away from access controls.

Regent Ruiz cautioned that the costs of unauthorized access to data and systems could be significant. He asked that the report include information on the cost to UC of insufficient access controls. Chief Compliance and Audit Officer Vacca noted that the internal audit program had also arrived at similar findings. Situations like these, when basic controls are neglected, sometimes arise due to budget reductions and employee transitions. Addressing these situations is complicated by the fact that there are many points of access to the University's systems.

Regent Makarechian commended the University on resolving outstanding Management Corrective Actions. He expressed concern that the University appeared to have written off the federal government's liability in the DOE matter discussed earlier. This payment was a guarantee from the federal government. According to information in the Required Communications to The Regents' Committee on Compliance and Audit, the DOE had provided no guarantee for payment. He asked why this amount would not be reported as a receivable when there is a contract and a guaranteed obligation. Ms. Arrivas responded that from an accounting perspective, because payment of this amount depended on approvals outside the University's control and because these funds were not available to pay retirees, the amount could not be called a receivable. In the past, the federal government has paid in February every year. This year, the government did not pay the amount, and it would not make sense to give the government credit for this asset in the government's actuarial calculation of the value of its pension assets.

Regent Makarechian expressed concern about a contract or guarantee for payment which depended on an approval process, and that any contract with any entity with future payment guarantees would be put in question. Ms. Arrivas responded that this would not be the case for any contract. Mr. Taylor added that this case was different because the U.S. Congress must pass an act to approve payment, unlike other contracts.

Regent Makarechian questioned the meaning or value of such a guarantee. Laboratory employees assume that their payments would be made by the federal government. Ms. Arrivas responded that the employees at LANL and LLNL were no longer covered by the UCRP, but by a different pension plan that was established with the new management of the Laboratories under joint venture LLCs. The liability now being discussed was specifically for retirees who had retired on the day of or prior to the separation to the LLC structure. The DOE accepted responsibility for paying off all pension benefits previously promised to these employees. The accounting reflects the payment schedule under the contract. The University reported these receivables on June 30, giving the DOE credit for these assets, which were scheduled to be paid the following February. The University was now aligning its accounting with the actual time of appropriation and payment.

Regent Makarechian asked about subsequent communications from the federal government. Ms. Arrivas responded that the University had not received a subsequent communication. The payment was due to the University on February 28. The University received a partial payment, and another partial payment several months later. In July, the University wrote a letter to the DOE about the receivables and inquiring about payment. The University has not received a written response to its letter. The University knows from conversations with the DOE that four congressional committees must approve the payment.

Regent Makarechian expressed concern that the University appeared to have written off the DOE's obligation or was giving the government the ability to claim that it no longer had an obligation to pay the amount. Ms. Arrivas responded that this was not the case. Mr. Taylor added that the University had to make a change in its wording because it did not want to mislead readers in its financial reports, but it also believes that the DOE will comply with its contractual obligation. Ms. Arrivas stressed that the University's contract with the DOE is enforceable. By leaving this amount out of its financial statements, the University had not sacrificed its rights under this contract. If payment is not forthcoming, the University would certainly make use of the rights it has. Mr. Taylor emphasized that the University had not written off this obligation; too much money was at stake. General Counsel Robinson stated his view that the University had not harmed its own position regarding the DOE's obligation.

Regent Makarechian referred to another item reported under "Significant or Unusual Transactions" in the Required Communications to The Regents' Committee on Compliance and Audit, the transfer of private equity partnership interests, and asked about the materiality of this transfer. Ms. Arrivas summarized the transaction, noting that private equity partnerships were transferred into a separate entity; then a portion of that entity was sold. This was a way for the University to liquidate some assets in its private equity portfolio.

Regent Makarechian asked about the standard or measure of materiality for this transaction. Ms. Arrivas responded that most of this private equity was in the UCRP. It was not considered material and does not affect UC's financial statements.

Regent Makarechian asked why this transaction would not be considered material, given that it involved a large dollar amount. Ms. Arrivas responded that the transaction occurred after the year end and there were no changes to the financial statements as a result. University management determined that no discussion of this transaction was needed in the financial statements because there were no changes to the statements as a result of the transaction. The interests are still a private equity partnership and still an investment.

Regent-designate Engelhorn asked who would be responsible to pay the $80 million discussed earlier, if funds had to be paid before they were received. Ms. Arrivas responded that this was a DOE obligation. Mr. Mara explained that the pension fund for the two LLCs in question was adequately funded to cover all current obligations. The federal government was in arrears in relation to its normal schedule. The University has expressed its position that this is not acceptable, even though the government finds itself in unusual circumstances. The DOE has identified the $80 million still owed the University and has submitted this through the congressional committee process. Mr. Mara stated that the DOE has responded in good faith to the University's criticism and that UC expects the DOE to make good on its contract obligation when the congressional approvals are secured. Mr. Taylor added that there were sufficient monies in the LLC pension fund to last for decades. The University is entitled to the $80 million, is seeking this money, but does not need it in the near future to pay retirees.

Committee Chair Zettel expressed the hope that this matter was on the agenda of the relevant congressional committees. She praised the quality of the University's financial reports for the current year. She recalled that the external auditor had sent letters about concerns to four campuses. She asked if these were the same locations where concerns had been reported the previous year. Ms. Arrivas responded that some locations were the same as the previous year, and some were different. The four campuses that received letters were Irvine, San Diego, Davis, and Los Angeles.

Committee Chair Zettel asked if the issues raised in the letters were new, and if the previous year's issues had been attended to. Ms. Murphy referred to a chart showing the status of prior year comments in the Report to The Regents' Committee on Compliance and Audit. Logical security access controls are typically an ongoing concern, although not repeatedly at the same locations. In the previous year there were 21 findings at locations; 15 had been addressed and six were currently being corrected. PwC's comment on logical security access controls was repeated this year, with some new nuances. The comment on segregation of duties was new this year. Ms. Arrivas referred to the letters to campuses, noting that some of the comments in those letters were new, while others were comments on issues still being corrected. She stressed that all issues were being addressed at all locations.

3. **ANNUAL REPORT ON ETHICS AND COMPLIANCE 2012-13**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Chief Compliance and Audit Officer Vacca stated that UC's compliance program represents best practices in the industry, even though dedicated resources are not available everywhere in the UC system. She recalled that at several campuses an individual with other job responsibilities also serves as the campus' ethics and compliance officer. Senior leadership at UC was effectively communicating a culture of compliance to UC with a positive tone. Instances of non-compliance are sometimes due to the fact that employees do not know what is expected of them. The ethics and compliance program had identified and would focus its efforts on risk in the areas of research compliance, data privacy and security, government reimbursement accuracy, health care billing and coding, and campus safety.

Committee Chair Zettel commented on the royalty audit program, which had identified more than $1,298,000 in underpayments. She expressed appreciation for this result, noting that these funds would have a positive impact on UC educational programs. She praised the symposia and education sessions offered by Ethics, Compliance and Audit Services, which are attended by representatives of other institutions and demonstrate UC's leadership in the higher education arena in California. Ms. Vacca added that UC is part of an inter-university consortium including the University of Washington, University of Texas, the California Institute of Technology, and the California State University. These universities have shared resources and improved efficiencies.

Committee Chair Zettel referred to increased reporting to the UC whistleblower hotline and praised the University's response in addressing these cases.

Staff Advisor Barton asked about the 30-percent increase in reporting to the UC whistleblower hotline over the previous year. She asked if this increase could be attributed to heightened awareness, or this in combination with other factors. Ms. Barton noted that 77 percent of those who reported through the hotline chose to remain anonymous. Referring to the remaining 23 percent, she asked why these employees chose to use the hotline rather than direct communication through departmental structures. Ms. Vacca responded that heightened awareness would account for the increase in reporting. At UC as in other settings, employees use the hotline because they may not be comfortable communicating through the existing chain of command. Another reason for an employee to use the hotline is that he or she can monitor the situation, see if it is being addressed, and call back. In the case of hotline calls that are not anonymous, Ms. Vacca suggested that these individuals might choose not to work through the usual mechanisms or the chain of command because of greater confidence that something will be done to address the situation if it is reported through the whistleblower hotline system, where every issue is tracked to resolution.

Regent Ruiz asked if successful audit processes used for financial areas could be expanded to other areas. Ms. Vacca responded in the affirmative, noting that the audit process was becoming more collaborative.

4. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES 2012-13**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Chief Compliance and Audit Officer Vacca noted that there are dedicated auditors at each UC location. In the past year, the internal audit program issued 334 reports with many recommendations. There were no significant weaknesses or deficiencies to report. Lack of sufficient controls in some areas reflected budget reductions at UC. Audit efforts have been focused especially in research and health science, which operate in a stringent regulatory environment. With limited resources, the audit program identifies priorities and develops a risk-based plan. Ms. Vacca expressed confidence in the skill of UC's internal auditors. The professional experience of UC's internal auditors ranges from 14 to

27 years, remarkable for any organization. For this reason, succession planning is also important.

Committee Chair Zettel noted that the number of Management Corrective Action (MCA) closures exceeded the number of new MCAs and praised the program's work.

Regent Ruiz referred to the list of significant and recurrent internal control issues, and suggested the addition of the areas of construction and athletics. Ms. Vacca responded that internal audit has carried out a survey of UC's athletic programs. Construction has been included in campus-based audit plans; this topic was also being addressed.

Committee Chair Zettel noted that a number of audits had been carried out on construction projects of under $60 million, with delegated authority. She encouraged Ms. Vacca to continue with these audits, ensuring that monies reported to be invested in and used for construction were in fact applied appropriately to meet stated targets and goals.

5. **STRATEGIC UPDATE ON INFORMATION TECHNOLOGY SERVICES**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Executive Vice President Brostrom introduced Tom Andriola, the new Vice President and Chief Information Officer. Mr. Andriola would manage the Information Technology Services department at the Office of the President and would provide leadership, consistent with the July 2010 directive from the Regents, to explore shared services to achieve systemwide efficiencies as well as other technology innovations at UC. Mr. Andriola was uniquely qualified for this role, with more than 20 years of experience as a technology leader and business executive, leading technology initiatives to reduce costs, streamline processes, and create new value propositions. Mr. Andriola previously worked at Philips Healthcare, where he served most recently as vice president and general manager of software and technology services, which generated more than $100 million in revenue growth through the development of disruptive innovation, with teams operating on four different continents. Before that, Mr. Andriola served at Philips as an information technology executive, driving a business harmonization program that improved the company's financial position by more than $200 million, including the implementation of a global shared services unit. Mr. Andriola had also worked for various technology organizations as a global chief information officer, technology strategist, and business reengineering consultant. He had recently met with UC campus leadership and chief information officers in order to develop an appropriate strategic plan. Mr. Brostrom suggested that Mr. Andriola present an update at a future meeting on what he had learned and what he saw as opportunities for the University in this area.

Mr. Andriola expressed excitement about working at the University. His visits to the campuses and medical centers had given him an idea of their unique nature. He stressed the breadth and impact of the University and looked forward to working on opportunities to make the University even better.

Regent Newsom urged the Regents to engage in a serious conversation about the University's approach to information technology, a robust conversation about strategy in this very important area that requires a significant investment in time and funds. Mr. Brostrom suggested that an update could be presented in January or March 2014, as well as an update on UCPath, the new payroll system.

The meeting adjourned at 3:34 p.m.

Attest:

Secretary and Chief of Staff