

The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT

November 18, 2015

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

Members Present: Regents Gorman, Makarechian, Oved, Sherman, and Zettel; Staff Advisors Acker and Richmond; Expert Financial Advisor Juline

In attendance: Regent Davis, Regents-designate Brody and Schroeder, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Executive Vice President and Chief Financial Officer Brostrom, Chancellor Hawgood, and Recording Secretary Johns

The meeting convened at 1:45 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 July 21, 2015 were approved.

2. AMENDMENT OF INTERNAL AUDIT CHARTER

The Senior Vice President – Chief Compliance and Audit Officer recommended that the Committee on Compliance and Audit recommend to the Regents that the Internal Audit Charter be amended as shown in Attachment 1.

[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 explained that the proposed amendment of the Internal Audit Charter would reinforce reporting structures and independence where appropriate.

Regent Makarechian asked Ms. Vacca if she was able to report incidents of non-compliance directly to the Board of Regents, completely independently of the Office of the President. Ms. Vacca confirmed that this was the case. She could bring any issue of concern to the Committee and the Board.

Upon motion duly made and seconded, the Committee approved the Senior Vice President – Chief Compliance and Audit Officer’s recommendation and voted to present it to the Board.

3. ANNUAL REPORT ON ETHICS AND COMPLIANCE ACTIVITIES 2014-15

[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 presented a chart that illustrated the very large number of agencies or regulatory bodies to which the University is legally obligated to report. She estimated that there might be 250 to 260 such agencies. She briefly discussed compliance and benchmarking efforts.

Regent Davis asked if the University has internal procedures to determine when it needs to develop new compliance expertise due to new research programs and initiatives. Ms. Vacca responded that these instances might be addressed locally rather than centrally, and would not necessarily be reported to her office. General Counsel Robinson added that his office tries to meet such needs with existing resources, or seeks outside assistance.

Regent Makarechian cautioned that non-compliance on even a small project might jeopardize funding for other, larger projects and initiatives. Ms. Vacca responded that UC's international activities are a key area of risk. The University tries to address this risk through training and appropriate resources.

Staff Advisor Acker stressed the importance of retaining skilled staff in compliance. Ms. Vacca concurred.

Committee Chair Zettel noted that many UC students study abroad. She referred to the recent terrorist attacks in Paris, France, where a California State University Long Beach student was killed. Ms. Vacca responded that the Office of Risk Services tracks UC students and affiliates abroad, and focuses on their safety and well-being.

Deputy Compliance Officer David Lane briefly outlined highlights of UC ethics and compliance activities in 2014-15. Compliance programs are designed to be preventative and respond to risk in advance. It is difficult to quantify the savings garnered by such programs. This return on investment includes avoiding fines, mitigation of reputational risk, and prevention of loss of revenue. A major effort of UC's ethics and compliance program is education and training, with a broad range of programs and topics. Ms. Vacca added that the main reason for non-compliance is lack of knowledge. Mr. Lane noted other major efforts in privacy and information security, research and export control, healthcare regulations, international compliance, and campus climate and safety.

4. ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES 2014-15

[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 reported that there were no significant weaknesses in controls to report or other disclosures for the Committee.

Systemwide Audit Director Matthew Hicks briefly outlined some highlights from the Annual Report on Internal Audit Activities. There was effective cooperation from management in carrying out the audit. The audit program showed good levels of productivity and audit completion. Top issues were information technology security, research compliance, and large-scale system implementations, such as UCPath. Ms. Vacca added that the audit program would continue to focus on UC's joint ventures.

Mr. Hicks discussed a chart showing that audit staff turnover had been decreasing. The level of experience among audit staff remains high, in terms of years of experience. There is a certain gap between levels of experience for new staff and staff who have been at UC for many years. Over 66 percent of audit staff had been at the University for more than ten years. Succession planning and development of staff expertise would be increasingly important in the coming years.

Mr. Hicks then displayed a chart showing effort distribution in the audit program among audits, advisory services, and investigations. The bulk of program effort remains in audits; however, the program recognizes the importance of advisory services. The areas in which most audit effort was expended were health sciences, financial management, academic departments, and information technology. In conclusion, Mr. Hicks remarked on trends in Management Corrective Actions (MCAs). Overall, the trend had been favorable for closure of MCAs, including MCAs open over 300 days, although there had been a recent uptick.

Regent Makarechian asked about the reason for the recent uptick and suggested that MCAs be broken down and presented by category so they could be addressed more effectively by chancellors or the Committee. Ms. Vacca responded that many audits are in information technology. One audit can lead to several MCAs. The reasons for the recent increase were not known.

5. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2015**

[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.]

KPMG representative Mark Thomas began the discussion by noting that there were no significant items among the Required Communications to The Regents' Committee on Compliance and Audit.

Regent Makarechian recalled that the financial statements for the medical centers had been combined into one document. He requested confirmation that the materiality threshold was determined for each medical center individually, not for all the centers combined, so that smaller items would not go unnoticed. Mr. Thomas responded that the

series of financial reports provided to the Regents included systemwide financial statements, as well as statements for the medical centers, and for the UC Retirement System. In preparing the annual financial report for the UC system, KPMG performs an audit of the entire system, including every entity. For that audit, KPMG calculates materiality on a systemwide basis, taking into account all revenues. Mr. Thomas then explained that while the medical center reports were provided in one document, each medical center is audited separately. KPMG's opinion refers to each individual medical center separately, and each medical center has its own materiality calculated separately. He concurred that if one used the materiality threshold for the system as a whole for each medical center, much information would be lost, but he stressed that this is not the case; each medical center is subjected to an individual audit with its own materiality. Associate Vice President Peggy Arrivas added that this was the same procedure that UC used previously, when the medical center financial reports were presented in separate documents.

Regent Makarechian asked if the materiality threshold for each medical center was two percent. Ms. Arrivas responded in the affirmative.

Regent Makarechian asked how KPMG audits the unfunded liabilities of the UC health system. Mr. Thomas responded that KPMG examines the overall liability of the UC system, working with the University's actuary and KPMG's own actuary. The allocation process, allocating liabilities to the various entities, is addressed by the actuary. In response to another question by Regent Makarechian, Mr. Thomas explained that KPMG reviews the qualifications of UC's actuary and all the assumptions being used. KPMG carries out an independent, side-by-side assessment of the work done by UC's actuary to verify that actuary's calculations.

Regent Makarechian asked where KPMG renders this opinion. Mr. Thomas responded that this opinion is included in the financial statements, but not issued as a specific public opinion.

Regent Makarechian emphasized that this unfunded liability is a large number and that there were complex new reporting requirements. It is important for the University to ensure that this number has been verified independently. Mr. Thomas responded that KPMG spends a significant amount of time verifying these figures. The University's and KPMG's actuaries come together to work through the assumptions. He concurred that the new requirements were complex.

Regent Makarechian stated his view that the figures for this liability should be specifically referenced. Ms. Arrivas commented that the University develops assumptions for the valuations with its actuary and then shares those assumptions with the KPMG actuary for review. She recalled that a few years previously, UC had an independent actuary re-perform the actuarial work and re-calculate within a one- to two-percent threshold. The University would do this again in the current year. Having an independent actuary perform a review is an industry best practice, and UC carries out this process every three to five years.

Regent Makarechian asked if the University could render a specific opinion and confirm these numbers. Ms. Arrivas responded that these numbers were in the footnotes to the financial statements. The KPMG opinion covers not only the financial statements themselves, but all the footnotes as well. Mr. Thomas confirmed this.

Committee Chair Zettel praised the easily readable format of the annual financial reports. The presentation of facts in brief was helpful. She commented on a reduction in capital gifts and grants and expressed disappointment that the University had a lower expenditure in operations and maintenance. UC's investment returns were encouraging, but the growth of the UC pension and health benefits debt since 2011 was a cause for unease. Executive Vice President and Chief Financial Officer Brostrom responded that some changes were due to accounting standards and to the change in the discount rate. Because the return assumption for the UC Retirement Plan (UCRP) has changed, liability would increase.

Committee Chair Zettel noted that the California Public Employees' Retirement System (CalPERS) was adjusting its assumption rate. She asked if the University was thinking of further reducing the assumption for the UCRP. Mr. Brostrom recalled that the UCRP assumed rate of return had been at 7.5 percent from 1992 and was recently lowered to 7.25 percent. The CalPERS assumption had been higher than that for UCRP; it was currently at 7.5 percent, but CalPERS had announced that it would lower its assumption to 6.5 percent using a formula that would be implemented fully over a decade. He noted that UC's investment returns, smoothed over five years, were at 10.2 percent. The University would discuss the possibility of further lowering its investment return assumption.

Regent Makarechian saw the decrease in maintenance costs referred to by Committee Chair Zettel as a positive sign that UC buildings were being better constructed. He asked about actuarial assumptions for retiree health benefits. Ms. Arrivas explained that the retiree health benefit numbers in the financial statements were based on a discount rate of 5.5 percent, but the valuation for the UC Retiree Health Benefit Program to be provided by the Regents' consulting health actuary in the Committee on Finance would be based on a discount rate assumption of 4.5 percent. This accounted for the increase mentioned by Mr. Brostrom. About \$300 million of this expense was in cash and about \$1 billion was a non-cash expense. The University was building a future liability it would have to pay. Ms. Arrivas referred to Committee Chair Zettel's remarks on various line items. She explained that State capital appropriations declined because the University had refinanced State Public Works bonds. Now, instead of receiving State capital appropriations, UC would receive State educational appropriations. Capital gifts and grants tend to fluctuate when campuses carry out large capital campaigns. There had been significant campaigns recently, such as that for the UCSF Mission Bay Hospital.

Mr. Brostrom announced that implementation of the UCPath system had begun at the Office of the President and paychecks for this location, bi-weekly and monthly, would be issued by UCPath. Ms. Arrivas added that the UCPath Center would officially open for business on November 30. The system was up and running.

Regent Sherman asked how many checks UCPATH would issue. Ms. Arrivas responded that there were about 1,800 employees at the Office of the President. Less than ten percent of these paychecks would be paper checks; most would be direct deposits.

Regent Makarechian asked about the next stage of UCPATH implementation. Ms. Arrivas responded that the next planned stage would encompass UCLA, UC Riverside, UC Merced, and Associated Students UCLA.

6. **INDEPENDENT ANALYSIS OF THE UC MERCED 2020 PROJECT COST MODEL AND ASSUMPTIONS FEES**

[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 Peggy Arrivas explained that KPMG was asked to carry out an independent review of the UC Merced 2020 Project cost model and assumptions. The fees for this review were \$193,000, a small amount compared to KPMG's annual audit fees. This additional review was viewed as a positive step.

The meeting adjourned at 2:40 p.m.

Attest:

Secretary and Chief of Staff

Proposed Revisions to Internal Audit Charter

Additions shown by underscoring; deletions shown by strikethrough

Internal Audit Charter

(Charter Revised ~~May 2011~~, ~~Vision and Mission Sections Revised March 2014~~)

Policy Statement

It is the policy of the University of California to maintain an independent and objective internal audit function to provide the Regents, President, and campus Chancellors with information and assurance on the governance, risk management and internal control processes of the University. Further, it is the policy of the University to provide the resources necessary to enable Internal Audit to achieve its mission and discharge its responsibilities under its Charter. Internal Audit is established by the Regents, and its responsibilities are defined by The Regents' Committee on Compliance and Audit as part of their oversight function.

Vision

UC Internal Audit will be a universally recognized knowledgeable, collaborative and trusted resource on governance, risk management and control.

Mission

The mission of the University of California (UC) internal audit (IA) is to provide the Regents, President, campus Chancellors, and Laboratory Director independent and objective assurance and consulting services designed to add value and to improve operations. We do this through communication and collaboration with management to assist the campus community in the discharge of their oversight, management, and operating responsibilities. IA brings a systematic and disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes.

Authority

IA functions under the policies established by the Regents of the University of California and by University management under delegated authority.

IA is authorized to have full, free and unrestricted access to information including records, computer files, property, and personnel of the University in accordance with the authority granted by approval of this charter and applicable federal and state statutes. Except where limited by law, the work of IA is unrestricted. IA is free to review and evaluate all policies, procedures, and practices for any University activity, program, or function.

In performing the audit function, IA has no direct responsibility for, nor authority over any of the activities reviewed. The internal audit review and approval process does not in any way relieve other persons in the organization of the responsibilities assigned to them.

Independence and Reporting Structure

To permit the rendering of impartial and unbiased judgment essential to the proper conduct of audits, internal auditors will be independent of the activities they audit. This independence is based primarily upon organizational status and objectivity and is required by external industry standards.

The Senior Vice President - Chief Compliance and Audit Officer (CCAO) has a direct, independent reporting relationship to The Regents, communicating directly with the Board of Regents and the Regents Committee on Compliance and Audit regarding all elements of meaningful compliance and audit programs, including providing annual reports on compliance with applicable laws, regulations, and University policies. The CCAO shall also consult with and advise the President on compliance and audit activities. The CCAO has established an active channel of communication with the Chair of The Regents' Committee on Compliance and Audit, as well as with campus executive managements, on audit matters. The CCAO has direct access to the President and The Regents' Committee on Compliance and Audit. In addition, the CCAO serves as a participating member on all campus compliance oversight/audit committees.

Campus/Laboratory Internal Audit Directors (IADs) report administratively to the Chancellor/Laboratory Director ~~(or designate)~~ and directly to The Regents' Committee on Compliance and Audit through the CCAO. IADs have direct access to the CCAO and to the President or The Regents' Committee on Compliance and Audit as circumstances warrant.

Campus IADs will report periodically to the campus compliance oversight/audit committees on the adequacy and effectiveness of the organization's processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work; the status of the annual audit plan, and the sufficiency of audit resources. The local audit functions will coordinate with and provide oversight of other control and monitoring functions involved in governance such as risk management, compliance, security, legal, ethics, environmental health & safety, external audit, etc.

IADs may take directly to the respective Chancellor or Laboratory Director, the CCAO, the President, or The Regents matters that they believe to be of sufficient magnitude and importance. IADs shall take directly to the CCAO who shall report to the President and The Regents' Committee on Compliance and Audit Chair, any credible allegations of significant wrongdoing (including any wrongdoing for personal financial gain) by or about a Chancellor, Executive Vice Chancellor or Vice President, or any other credible allegations that if true could cause significant harm or damage to the reputation of the University.

The Chancellors/Laboratory Director may delegate other IAD administrative oversight responsibilities such as time and expense approval and departmental budget oversight to a position no lower than the Vice Chancellor/Associate Laboratory Director or Chief Operating Officer level. To maintain organizational independence, this position should generally not have responsibility over key operating units routinely reviewed by internal audit. If Chancellors/Laboratory Director, when pursuant to their re-delegation authority, designate a position to whom the IAD shall report, that position shall be at least at the Vice

~~Chancellor/Deputy Laboratory Director level and the~~ The Chancellor/Laboratory Director shall retain responsibility for: approval of the campus/laboratory annual audit plan; approval of local audit committee/work group charter; and shall meet with the IAD ~~at least annually~~ regularly to review the state of the internal audit function and the state of internal controls locally. The Regents have the ultimate authority to approve and/or amend the systemwide audit plan, which is a consolidation of all campus and laboratory audit plans. ~~When reporting responsibility is re-delegated, IADs also have direct access to Chancellors/Laboratory Directors as circumstances warrant.~~

Scope of Work

The scope of IA work is to determine whether UC's network of risk management, control, and governance processes, as designed and represented by management at all levels, is adequate and functioning in a manner to ensure:

- Risk management processes are effective and significant risks are appropriately identified and managed.
- Ethics and values are promoted within the organization.
- Financial and operational information is accurate, reliable, and timely.
- Employee's actions are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Resources are acquired economically, used efficiently, and adequately protected.
- Programs, plans, and objectives are achieved.
- Quality and continuous improvement are fostered in the organization's risk management and control processes.
- Significant legislative or regulatory compliance issues impacting the organization are recognized and addressed properly.
- Effective organizational performance management and accountability is fostered.
- Coordination of activities and communication of information among the various governance groups occurs as needed.
- The potential occurrence of fraud is evaluated and fraud risk is managed.
- Information technology governance supports UC strategies and objectives.

Opportunities for improving management control, quality and effectiveness of services, and the organization's image identified during audits are communicated by IA to the appropriate levels of management.

Nature of Assurance and Consulting Services

IA performs three types of projects:

Audits – are assurance services defined as examinations of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes

for the organization. Examples include financial, performance, compliance, systems security and due diligence engagements.

Consulting Services – the nature and scope of which are agreed with the client, are intended to add value and improve an organization’s governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include reviews, recommendations (advice), facilitation, and training.

Investigations – are independent evaluations of allegations generally focused on improper governmental activities including misuse of university resources, fraud, financial irregularities, significant control weaknesses and unethical behavior or actions.

Mandatory Guidance

IA serves the University in a manner that is consistent with the standards established by the SVP/CCAO and acts in accordance with University policies and *UC Standards for Ethical Conduct*. At a minimum, it complies with relevant professional standards, and the Institute of Internal Auditors’ mandatory guidance including the *Definition of Internal Auditing*, the *Code of Ethics* and the *International Standards for the Professional Practice of Internal Auditing*. This mandatory guidance constitutes principles of the fundamental requirements for the professional practice of internal auditing and for evaluating the effectiveness of the internal audit activity’s performance.

Certain Personnel Matters

Action to appoint, demote or dismiss the SVP/CCAO requires the approval of The Regents. Action to appoint an IAD requires the concurrence of the SVP/CCAO. Action to demote or dismiss an IAD requires the concurrence of the President and Chair of the Compliance and Audit Committee, upon the recommendation of the SVP/CCAO.