The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
November 2, 2010

The Committee on Compliance and Audit met on the above date by teleconference at the following locations: 1111 Franklin Street, Room 9204, Oakland; J. D. Morgan Center, Los Angeles campus; Student Services Center, Conference Room 554, San Diego campus; 1130 K Street, Suite 340, Sacramento.

Members Present: Regents Cheng, Hime, Ruiz, and Zettel; Advisory member Simmons; Expert Financial Advisor Schneider and Expert Compliance Advisor Guyton

In attendance: Faculty Representative Anderson, Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Executive Vice President Taylor, and Recording Secretary Johns

The meeting convened at 11:45 a.m. with Committee Chair Ruiz presiding.

1. **PUBLIC COMMENT**

Committee Chair Ruiz explained that the public comment period permitted members of the public an opportunity to address University-related matters. The following persons addressed the Committee.

A. Mr. Percy Castellanos, a graduate student at the School of Social Welfare at UC Berkeley and representative of the Social Welfare Graduate Assembly, expressed concern about the soundness and adequacy of the School's financial plan and about the School's compliance with the California Public Records Act. He communicated students' concerns that the School's multi-year plan for setting Professional Degree Fee levels did not provide enough information about or a rationale for the allocation of fee revenue and other funds, and that the dean and assistant dean did not have a working knowledge of the budget.

B. Ms. Robyn MacConnell, a graduate student at the School of Social Welfare at UC Berkeley and representative of the Social Welfare Graduate Assembly, reported that students have requested the current working budget for the School, the budget for the past five years, and a projected five-year financial plan, but have not yet received a response. She requested these materials from the Committee and hoped that the University would investigate students' concerns about a possible lack of sound financial planning within the UC Berkeley School of Social Welfare.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2009-10**

[Background material was mailed to the Committee 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 briefly presented the Annual Report on Internal Audit Activities for 2009-10. She called attention to the challenge to the internal audit program this year presented by the reduced number of employee hours during the furlough plan; nevertheless the program was productive. The program focused on controls to a greater degree than on consultation and advisory services, but did maintain its advisory function in the areas of governance, compliance, and budgeting. Overall, the program completed 555 audits and produced 437 reports, with 1,914 recommendations for improvements in internal controls. Management Corrective Actions (MCAs) are being monitored. The internal audit program exceeded its benchmarks for productivity for the fiscal year and completed 95 percent of its audit plan.

The internal audit program identified no material deficiencies in the University's internal controls from a financial standpoint. There was no interference with the program's activities; management was collaborative.

Although there were no material control deficiencies, Ms. Vacca discussed areas in which the University could implement more effective controls: information technology and information privacy, segregation of duties, disaster recovery planning, regulatory compliance, and charge capture and billing at the medical centers. Reports on progress in these areas would be provided at future meetings.

Regent Zettel praised the quality of the internal audit staff's work, which was achieved in spite of furloughs.

3. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2010**

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

PricewaterhouseCoopers (PwC) representative Joan Murphy presented the Annual Report of External Auditors for the Year Ended June 30, 2010. She briefly identified some of the key PwC employees and teams involved in the UC audit.

Faculty Representative Simmons asked how many PwC employees are engaged on the UC audit. Ms. Murphy responded that there are about 100 PwC employees engaged, working in teams with from two to five members. In order to accomplish the audit work, PwC must deploy a large number of individuals at the same time.

The PwC audit includes opinions on the University's consolidated financial statements and three retirement plan reports, on the defined benefit plan, the defined contribution plan, and the health and welfare plan. PwC issues five opinions for the five stand-alone sets of financial statements for the medical centers. PwC provides a report on internal control procedures at Lawrence Berkeley National Laboratory (LBNL). PwC issues individual letters to chancellors with recommendations on internal controls, if warranted. PwC carries out National Collegiate Athletic Association (NCAA) audits at six campuses, reports on Agreed Upon Procedures for certain loan portfolios, and conducts the A-133 audit, which concerns the University's compliance with federal award programs.

Ms. Murphy provided an overview of the Required Communications to The Regents' Committee on Compliance and Audit, which she described as the core document of the audit. PwC conducts the audit in accordance with generally accepted auditing standards and government auditing standards. The audit is not designed with a focus on internal controls, but PwC will share its observations on internal controls with UC management. The audit provides reasonable but not absolute assurance regarding detection of material fraud, because it does not test 100 percent of transactions.

In any given year, there can be new accounting pronouncements the University is responsible for implementing; there were two such pronouncements in the past year. Governmental Accounting Standards Board (GASB) Statement 51 concerns accounting for intangible assets such as patents or intellectual property. It did not have an effect on UC's financial statements. GASB Statement 53 concerns accounting for derivative instruments. The derivatives in the University's investment portfolio have always been carried on the balance sheet at fair value. The University determined that interest rate swaps at UC medical centers were derivatives, and these were included in the financial statements at fair value for the first time. Associate Vice President and Systemwide Controller Arrivas observed that much of the work in GASB 53 implementation involved the collection of disclosure data regarding investment derivatives included in the financial statements. Ms. Murphy explained that GASB allows lead time for implementation of its statements. About two years earlier, UC management alerted the locations to begin to inventory derivatives.

Faculty Representative Anderson asked if "fair value" was equivalent to "market value." Ms. Murphy responded that the terms have sometimes been used interchangeably. In the case of investments that are not readily traded, it is more appropriate to refer to "fair value."

Mr. Anderson asked if the process for determining the fair value of such investments was to examine similar investments which have a market value. PwC representative Ann Kennedy responded in the affirmative. There are various techniques for determining fair value, depending on the asset.

Ms. Murphy noted that the University's key accounting policies are disclosed in the footnotes to the financial statements. She then discussed judgments and accounting estimates, which are found throughout the financial statements. The University is self-insured for certain liabilities, and there must be estimates for these self-insurance reserves. There are also estimates for bad debt, fair value of certain investments, and pension benefits. Specialists and advisors assist in the development of these estimates. While the actual ultimate amount of a liability may differ from the estimate, it is the University's responsibility to develop the best estimates possible. PwC audits these estimates.

PwC representative Michael MacBryde discussed accounting estimates for the medical centers. The medical centers produce approximately $6 billion in patient-related revenue and have about $100 million in reserves. The revenue cycle at the medical centers is complex. Government payers can request refunds years after services are performed, and the Medi-Cal program in California presents many complexities. PwC engages specialists who are well acquainted with Medicare and Medi-Cal regulations to perform the audit in this area and includes medical center estimates for previous years in its analysis. Mr. MacBryde noted that changes in the medical center estimates were only $35 million, which indicates a tight estimation process. PwC also examines the valuation of receivables, including detail testing. PwC concluded that the methodology used to determine reserves was reasonable and generated appropriate levels, and that the controls for this process were sound.

PwC representative Ann Kennedy noted that management estimates are involved in the valuation of investments in two areas. The first area is alternatives or non-marketable securities, typically holdings in private equity and investment partnerships. She reported that the University's process for estimating the fair value of these investments is sound, and there were no matters of concern to bring to the Committee's attention. The second area is non-agency mortgage-backed securities, which account for only about two percent of the University's investment portfolio. This market has been very illiquid over the past 24 months, with some movement during the past 12 months. The University has made adjustments to the methodology, data, and assumptions it uses in its estimation process for determining fair value. PwC examined the valuation process and the data and assumptions used. The results were favorable; PwC found improvement in UC's estimation process. Ms. Murphy added that the University's alternative investments are audited, typically as of the December 31 year end.

Ms. Murphy then discussed audit adjustments. PwC tracked adjustments above certain dollar thresholds for its various UC audits. This procedure is based on the concept of materiality. Because PwC cannot audit every account or transaction, it considers those amounts which would be material to the University's financial statements. For the consolidated financial statements, the overall materiality threshold is $228 million; PwC tracks adjustments above $11 million. For the UC Retirement Plan (UCRP), PwC tracks adjustments above $34 million. Ms. Murphy observed that there were relatively few adjustments, given the size of the University. There were some out-of-period adjustments, regarding amounts from the prior year which should have been recorded differently. These were not significant.

Ms. Murphy then noted the possibility that there might be future changes to the financial statements for June 30, 2010. For example, a federal agency could audit compliance for a particular grant and request repayment. PwC has not observed significant changes to UC financial statements in the past.

The PwC location teams test for internal control deficiencies. PwC identified no significant deficiencies or material weaknesses. PwC issued three letters to chancellors regarding control deficiencies. Ms. Murphy observed that control deficiencies occurred at other locations as well, but were not significant enough to warrant the attention of a chancellor. PwC had no disagreements with management on accounting matters and encountered no difficulties in performing the audit. There was excellent cooperation from all locations. PwC's audit detected no fraud or illegal acts.

Ms. Murphy noted that NCAA audits are required to be issued by January 15. PwC intends to issue these audits before the end of the current calendar year; it intends to issue its A-133 audit by the end of January 2011. She concluded by calling attention to the Management Representation Letter, included as an appendix to the Required Communications to The Regents' Committee on Compliance and Audit.

Regent Zettel referred to the 2009-10 Annual Financial Report for the University of California. In the statements of revenues, expenses, and changes in net assets on page 33, under "Operating Expenses," there was a significant change in the cost of UCRP benefits from 2009 to 2010. Regent Zettel stated that the Regents must consider this as they develop policies to address these liabilities. Chief Financial Officer Taylor responded that this significant increase, from $69 million to almost $1.6 billion, reflected UCRP investment losses in the years 2007, 2008, and 2009. Investment gains and losses are smoothed over five years; this loss would be the first year of a few years of negative numbers.

Regent Zettel emphasized that the impact of this loss would reverberate throughout the University and affect students.

Mr. Anderson asked if this increase was the difference between the annual required contribution and the amount actually contributed to the UCRP. Associate Vice President and Systemwide Controller Peggy Arrivas responded that the expense is the annual required contribution. The liability on the balance sheet reflects the amount not paid. She referred to the statements of net assets on page 32 of the 2009-10 Annual Financial Report, where, under "Current Liabilities," the obligation to the UCRP was listed as $1.6 billion for 2010.

Mr. Anderson observed that the obligation to the UCRP listed for 2009 in the same table was only about $69 million. This reflected the fact that the University began that year with a modest surplus. The actual normal cost incurred by the University was $1.4 billion. Ms. Murphy observed that the University's actuarial valuation occurs at the beginning of the year. Mr. Taylor noted that there would be further discussion at the November Regents meeting on the difference between the actual contribution to the UCRP and the actuary's recommendation on the amount that should be contributed.

Mr. Anderson observed that there is a lag, due to the fact that the UCRP valuation for June 30, 2008 is used to determine the contribution for 2009-10. Ms. Arrivas noted that the valuation for July 1, 2010 would be presented to the Regents at the upcoming November meeting.

Committee Chair Ruiz asked if the UCRP valuation was moving in an appropriate direction. Mr. Taylor responded that the funded status of the UCRP would decline for a few years into the future as the University worked through the losses of the period around 2008. Proposals would be presented to the Regents at the upcoming meeting to address UCRP funding. Mr. Taylor emphasized that this problem would require a long-term solution.

Ms. Murphy referred to the Observations from Agreed Upon Procedures for LBNL. She reported that the audit found only one control exception.

PwC representative Jaime Jones provided comments on the Report to the Regents' Committee on Compliance and Audit for the Year Ended June 30, 2010. She noted that PwC identified no significant deficiencies or material weaknesses over the past year. This year PwC issued three letters to chancellors; the previous year it issued four. This year's Report to the Regents' Committee on Compliance and Audit contained two comments; the previous year it contained three. There has been improvement and a decrease in the number of control exceptions. PwC has received responses from management regarding the two comments in the current Report and PwC will track these issues over the course of the coming year. Regarding the first comment, Ms. Murphy emphasized the importance of internal controls to an institution the size of UC. It is a good practice for the locations to examine their controls continually for efficiency and effectiveness. The second comment concerned information technology controls and appropriate user access.

4. **WORKING SMARTER INITIATIVE: UCLA/UCSB PARTNERSHIP**

Chief Financial Officer Taylor recalled that one of the University's long-term goals is to develop common administrative systems, so that ten campuses use one administrative framework. This would include common integrated systems in finance and payroll, human resources, research administration, e-procurement, and other areas.

The University has established the UC Strategic Investment Program, which is designed to provide campuses with support for equipment financing, strategic retention efforts, and cross-campus collaborations. These cross-campus collaborations are regional centers of excellence, partnership efforts among campuses on major administrative systems. In one such collaboration, the Santa Barbara campus will migrate to the UCLA financial system over three years, beginning immediately. The University has put in place a $16.5 million no-interest loan to UC Santa Barbara, payable over seven years.

Associate Director for Strategic Initiatives Lisa Baird explained that, after implementation of this project at UC Santa Barbara, four UC locations will share the same financial systems – UCLA, UCSB, UC Merced, and the Office of the President.

The Santa Barbara campus has long been aware that its mainframe system needs to be replaced. With implementation, UCSB will have functionality in financial systems, e-procurement, accounting, budget, and reporting which it currently does not have, as well as other advantages.

Mr. Taylor outlined the loan authorization terms, which he described as favorable. He emphasized that use of a single financial system by four UC locations would provide momentum for other UC locations to migrate to this platform, as they seek to upgrade and replace existing systems.

Committee Chair Ruiz asked when systemwide implementation of a single financial system might occur. Mr. Taylor responded that he was not certain when this might occur, although he now felt more optimistic than he had in the past about the possibility of realizing this goal. He noted that some other campuses will have to begin to upgrade and replace their existing financial systems within the next two years. If six campuses were then using the same system, this might provide a tipping point at which the remaining campuses could be persuaded to migrate to the new system earlier than planned.

Committee Chair Ruiz asked that Mr. Taylor inform the Committee regularly about the progress of this effort, and to let the Committee know if he encountered any resistance. Mr. Taylor responded that he would do this. He stated that the project must be cost-effective and expressed his belief in allowing the campuses flexibility to ensure that the new system meets their individual needs. Partnership with the campuses would be essential to the success of this project.

Faculty Representative Simmons referred to the plan for two regional data centers and asked if the shared financial system would work from a common software platform. Mr. Taylor responded that this would be desirable. Appropriate backup for data was important. Use of regional data centers would improve data security and energy efficiency.

Faculty Representative Anderson noted that a large part of the cost of implementing a new financial system would be the cost of training employees who would work with the system. He asked if this cost was being taken into account. Mr. Taylor responded in the affirmative.

Mr. Anderson observed that this cost might serve as an argument for a campus' newly developed and well-functioning system to remain independent for some time. Mr. Taylor responded that this might be the case and that some existing systems work well for the campuses. The University would be thoughtful in pursuing this project.

5. **PAYROLL SYSTEM REPLACEMENT PROJECT**

Chief Financial Officer Taylor stated that the payroll system replacement project is the University's first major effort to develop a common administrative platform for all ten campuses.

Project Director Anthony Lo recalled that 11 different variants of the University's payroll system are being used throughout UC. The cost and maintenance needs associated with the existing system are a matter of concern. In addition, there are concerns about different data definitions and inconsistencies in decision support data provided by the system. At this time the University is losing key technical and functional expertise related to the payroll system due to retirements.

The goal of the current project is not simply to replace the existing payroll system. The project presents an opportunity to update technology and to develop more efficient and effective business practices. UC campus controllers, chief human resources officers, and academic personnel directors, all the key stakeholders in this process, have agreed on this point.

Mr. Lo outlined the progress to date. The University has conducted an extensive inventory of the campuses and medical centers in order to understand the current state of operational processes, existing problems, and opportunities for future efficiency gains. He stated that the University has an understanding of the high-level aspects of the situation, but is seeking more information about the differences among campuses and within each campus.

One positive aspect of the work so far is that stakeholders and participants in the process understand the need for a new system and have shown enthusiastic support for this effort. They recognize that the payroll system is 30 years old and that newer technologies are available. The University still spends a great deal of time on paper forms for employee attendance and hours worked. A short-term goal is to identify one campus solution as a common systemwide tool for tracking time and attendance before implementing the entire replacement system, which will take several years.

Mr. Lo then discussed the scope of the project. The UC Payroll Personnel System (PPS) serves functions beyond payroll. For the past 15 years, it has been the repository for information which does not fit well in other systems. PPS includes the human resources management system for many campuses which do not have separate human resources systems, as well as accounting and benefits calculation. In order to replace PPS, the University must replace not only the payroll functions, but these functions for human resources, accounting, and benefits calculation.

Mr. Lo provided a brief overview of the next steps in completing the replacement strategy assessment. These include determining the appropriate scope of the new system; identifying essential requirements, which are different for a complex institution of higher education than for industry; and understanding opportunities for centralization and the potential outsourcing of some activities. An architecture model for the system would be included in an interim report by December 31, 2010.

The next set of decisions is related to implementation. While the University wishes to achieve the benefits of a new system as quickly as possible, it must balance this against implementation risks. The system must be phased in an appropriate manner. In the following year the University would select a vendor and an implementation approach. Besides the software licensing costs, a significant effort would be required to achieve implementation. The year-end interim report would include a cost estimate and timeline. The final report, to be issued the following year, would include detailed requirements, final vendor selection, and resource planning.

Mr. Lo concluded that moving to a single payroll system would be challenging, but that the timing is right, as there is now a widespread understanding of relevant budget implications and the limitations of the existing system.

Faculty Representative Simmons asked if the University was contemplating one consistent system running on ten platforms or a centralized system on one platform. Mr. Lo responded that the University's goal for the payroll function is one centralized system for all the campuses. It has the same goal for the human resources systems, but given the current state of systems on the campuses, this would require a transition and phasing strategy. Mr. Taylor added that the University has not decided on the location of the central system, and that some functions may be outsourced.

Mr. Simmons referred to the plan for two regional data centers and asked if one center would provide backup for the other. Associate Vice President and Chief Information Officer Ernst responded in the affirmative. In addition, the two centers may have different capabilities. Ultimately, much of the University's general campus computing may be performed at a site outside UC. Mr. Simmons noted that this approach would prevent single source failure.

Regent Zettel asked if it would be possible to allow existing human resources systems to be integrated into the new system. Mr. Lo responded in the affirmative, noting that this was particularly true for certain specialized functions, such as those for academic personnel.

Committee Chair Ruiz observed that besides direct benefits, such as financial savings, this project presented an opportunity for significant indirect benefits, such as improved human resources and accountability functions. Mr. Taylor added that the functionality provided by a new system would save time and effort. As an example, it is difficult and time-consuming to obtain compensation information from the current system. The new system would be more efficient and better able to provide information in response to questions by the Regents and the public.

The meeting adjourned at 1:05 p.m.

Attest:

Secretary and Chief of Staff