The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
August 31, 2010

The Committee on Compliance and Audit met on the above date by teleconference at the following locations: 1111 Franklin Street, Room 5320, Oakland; Student Center, Aliso Beach A, Irvine campus; Board Room, James West Alumni Center, Los Angeles campus; Chancellor's Complex Conference Room, Building 108, San Diego campus; 1130 K Street, Suite 340, Sacramento.

Members Present: Regents Cheng, Hime, Island, Makarechian, Ruiz, and Zettel; Advisory member Simmons

In attendance: Regent-designate Mireles, 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 3:10 p.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. Ms. Amatullah Alaji-Sabrie, a representative of the Coalition of University Employees (CUE) and International Brotherhood of Teamsters Local 2010 and a UC Berkeley employee, referred to the University's project to implement a new payroll system and asked that this implementation include the active participation of clerical workers familiar with the existing systems. She expressed concern about the amount of UC funds spent to engage external consultants.

B. Ms. Dorthea Stewart, an employee at UC San Diego and member of CUE, expressed concern about the cost of engaging PricewaterhouseCoopers for a payroll cost study and possible conflict of interest.

2. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of July 15, 2010 were approved, with Regents Cheng, Hime, Island, Makarechian, Ruiz, and Zettel (6) voting "aye." [1]

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[1] Roll call vote required by the Bagley-Keene Open Meeting Act [Government Code §11123(b)(1)(D)] for all meetings held by teleconference.

3. **APPROVAL FOR PRICEWATERHOUSECOOPERS TO PERFORM PAYROLL COST STUDY**

The President recommended engaging PricewaterhouseCoopers to update the payroll cost study prepared in 2000 for the University.

[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 Financial Officer Taylor recalled that the University issued a Request for Information to various consultants the previous fall to assist UC staff in designing a process for implementation of a new systemwide payroll system. The University received responses from several qualified firms and selected Towers Watson as its lead consultant.

The project has four phases; two of the four phases are largely completed. At the end of the second phase, Mr. Taylor and others made the decision to terminate the University's relationship with Towers Watson, due to concerns about personnel and quality of work. The University also determined that two of its staff members have competence in payroll system development issues. Thus, rather than engaging another consultant, UC could delegate certain parts of the third and fourth phases of the project to other consultants. In this case, PricewaterhouseCoopers (PwC) was the second-place candidate after Towers Watson in the Request for Information process. The current proposal was to engage PwC for one particular project which belonged to the overall scope of the work originally to be performed by Towers Watson. The project would allow UC to determine the cost of its existing payroll system and the value of a new future system. It would be an update of a 2000 study conducted for the University by PwC. Because PwC is the University's external auditor, it is consistent with best practices to seek Regental approval for engaging PwC on this specifically defined project.

Committee Chair Ruiz asked if Regental approval was required because of the potential for conflict of interest. Mr. Taylor responded that the University must ensure that there is no conflict of interest. There have been discussions with PwC to ensure that its external audit team is not involved with this payroll study project. Associate Vice President and Systemwide Controller Peggy Arrivas added that this project is separate from the external audit by PwC. It does not fall within any category of services prohibited under the Sarbanes-Oxley Act or under Regental policy and it does not create a conflict of interest.

Regent Island requested clarification of the reason why this matter was brought before the Committee on Compliance and Audit, and not another Committee. Committee Chair Ruiz responded that this matter falls within the Committee's responsibilities as expressed in the Committee charter, Regents Policy 1400. He emphasized that there is meaningful value in the project. General Counsel Robinson observed that the payroll system is an important control mechanism; one of the functions of the Committee is to ensure that UC has adequate financial controls. It is also appropriate for the Committee to be advised of a case in which the University wishes to retain its auditor to perform consulting services and there is a potential for conflict of interest, and for the Committee to approve the engagement.

Regent Zettel asked if any information from the 2000 study would be included in the new study, and if that information was still pertinent. Mr. Taylor responded that the 2000 data were no longer pertinent and he expressed reluctance about basing decisions on them. He informed the Committee that expenditures on outside consultants for this project would not exceed costs planned in the original budget.

Regent Makarechian asked about the rationale for the new study, particularly when it is evident that payroll costs have increased since 2000. Mr. Taylor responded that there are a number of reasons for the study update. At the time of the earlier study, the University did not have a tenth campus and its medical centers were not nearly as large as at present. One finding of the 2000 study that was particularly troubling was the fact that, because the payroll and human resources functions were not centralized, 20 percent of work effort had to be performed a second time due to error. The University does not know whether this situation has improved or deteriorated since 2000. Updating the 2000 data would be useful to ascertain the amount and location of the University's expenses, to receive feedback from employees, and to develop a better product.

Regent Makarechian asked if PwC would propose a new consolidated system. Mr. Taylor responded in the negative. PwC would perform a cost study; a different consultant would assist the University with system selection. The University's goal is to provide the President with a set of recommendations for next steps and estimated costs by the end of the current calendar year. The next step would be a Request for Information or Request for Proposals in early 2011 to select a vendor. The University has not yet determined whether it will pursue an "off-the-shelf" product or outsourcing.

Regent Makarechian asked about the cost of the consulting agreement with PwC. Mr. Taylor responded that the University was still negotiating this. UC had budgeted $1 million with Towers Watson for consulting services. Mr. Taylor expressed confidence that the cost would remain at or below this level.

Regent Makarechian asked about a threshold or limit to the amount of consulting work the University's auditor may perform, and about possible conflict of interest. General Counsel Robinson expressed confidence that there would not be conflict of interest. PwC representative Joan Murphy stated that, besides UC policies, PwC must follow compliance requirements established by the American Institute of Certified Public Accountants (AICPA) and the U.S. Government Accountability Office to ensure that it maintains its independence. PwC has a rigorous internal process which has determined that this engagement does not threaten PwC's independence as an auditor. PwC employees are aware of which work they are not permitted to perform. Mr. Taylor stated that he was comfortable with the recommendation and that, if there were a conflict of interest in the future, it would be his responsibility to address it. Chief Compliance and Audit Officer Vacca expressed confidence that PwC was sufficiently independent and that there would not be conflict of interest. Committee Chair Ruiz stated his view that this engagement was a good business decision.

Faculty Representative Simmons asked when the new system might be implemented. Mr. Taylor responded that the University must move quickly with implementation; one campus has communicated that its existing payroll system would cease to operate within 24 months.

Regent Island requested clarification of what the Committee was approving. Committee Chair Ruiz noted that there are Securities and Exchange Commission (SEC) requirements regarding engagement of the University auditor for non-audit purposes. Mr. Taylor confirmed that, if he had decided to engage a different firm to conduct this study, this decision would not have required the Committee's approval. Committee Chair Ruiz, Regent Makarechian, and Mr. Robinson commented on the language of the recommendation.

Regent Island stated that he was comfortable with approval for the engagement of PwC, but expressed misgivings about approving funding for the study, a decision which should be left to the Office of the President. Regent Makarechian asked that the recommendation language be amended. Ms. Vacca suggested that the recommendation include language to the effect that PwC was being retained "to perform non-audit services."

Mr. Robinson proposed the following amended language for the recommendation: "The President recommends retaining PricewaterhouseCoopers (PwC), the Regents' external accounting firm, to perform non-audit services to update PwC's 2000 University payroll cost study, on terms to be determined by the President within his delegated authority."

Upon motion duly made and seconded, the Committee approved the President's recommendation as amended and voted to present it to the Board, with Regents Cheng, Hime, Island, Makarechian, Ruiz, and Zettel (6) voting "aye."

4. **ANNUAL REPORT ON COMPLIANCE 2009-2010**

[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.]

Chief Compliance and Audit Officer Vacca explained that the Annual Report on Compliance is a required report to the Regents. She first called attention to research compliance, an area of continued focus for the University where there are many potential risks. Specific topics of interest included in research compliance are conflict of interest policies and regulations, effort reporting compliance, and intellectual property compliance. Another important area is health care compliance; more information on the University's efforts in this area would be provided at a future meeting.

Due to two compliance program vacancies, one at UC San Francisco and one at UCLA, the University's compliance program has made an effort to assist these campuses on an interim basis. Another effort has focused on medical billing and coding practices, which are of interest to external regulators.

In the area of data security and privacy, Ms. Vacca informed the Committee that the University has a new Systemwide Privacy Officer, Russell Opland. This position focuses on systemwide policies required by the Health Insurance Portability and Accountability Act (HIPAA), among other topics, and it allows the compliance program to work more closely with UC information technology personnel to reduce risk.

Ms. Vacca emphasized that the compliance program faces a significant task in working with UC constituents and increasing awareness of compliance issues. Each campus now has an ethics, compliance, and risk committee, chaired and staffed by high-level administrators. This kind of high-level focus on compliance is new for the campuses.

Regent Makarechian asked about the status of compliance officer positions at UCLA and UC San Francisco. Ms. Vacca responded that UCLA has a chief compliance officer for the health system, Martha Arvin. UCSF recently interviewed candidates for a campus compliance officer position, an offer is pending, and the campus hopes to have the position filled by November. The compliance officer position for the medical center is still vacant.

Regent Makarechian referred to a chart provided in the report and requested information on the number of substantiated allegations. Ms. Vacca responded that the system for processing allegations was in transition during this year; more exact data would be available in the following year. There were 693 allegations for the past year. She stated that she could provide information on the number of substantiated allegations.

Regent Makarechian suggested that information on financial impact be included with the statistics on allegations, for example, the dollar amounts involved in cases of fraud. The number of allegations alone might not be meaningful if one allegation involved $100 and another $2 million. Ms. Vacca responded that the Compliance program intends to include these metrics in future reporting.

Regent Ruiz emphasized the importance of measuring progress. He asked that future reports include metrics to show the progress the University is making in compliance and accountability. Ms. Vacca responded that metrics were being developed for several areas.

5. DISCUSSION REGARDING CYBER INSURANCE AND BEST PRACTICES

[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 Financial Officer Taylor introduced this item, which concerned the University’s first insurance policy for cyber risk. He announced that Chief Risk Officer Crickette successfully secured coverage for the University for cyber risk effective July 1, 2010.

Ms. Crickette noted that this is the University's first cyber policy for information security breaches. It is also the first policy ever to be written in the insurance market which ties coverage to the condition that the insured organization follow its own policies and best practices. Previous attempts to obtain cyber insurance for UC were not successful, primarily due to the decentralized nature of the University's information technology systems. Data security breaches lead to both direct costs and indirect costs. The latter include risk to UC's reputation.

The new insurance policy addresses many areas for which the University previously had no coverage or only limited coverage. Ms. Crickette described the policy as "reverse underwriting." It would not be cost-effective for UC to purchase a traditional insurance policy for cyber risk. The new policy is written based not on current conditions, but on UC policy standards and efforts to improve procedures and controls. Ms. Crickette acknowledged the work carried out by UC Berkeley Associate Vice Chancellor and Chief Information Officer Shelton Waggener in developing the language for the policy and in educating underwriters about UC policies. The policy is meant to serve as a positive inducement for chief information officers on UC campuses to move computer servers or information systems to centralized, protected locations. Those who meet UC policy standards and follow UC's own best practices will receive this insurance coverage.

Regent Hime asked about the cost of this coverage. Ms. Crickette responded that the premium is $500,000, a small percentage of the cost of UC's total insurance program. She emphasized that this coverage applies to the entire UC system, and that the policy is written not to existing conditions, but to UC's best practices.

Regent Hime asked who the insurance providers are. Ms. Crickette responded that the insurance is provided by multiple insurance carriers, including Aspen Insurance.

Regent Hime asked if this is pooled coverage. Ms. Crickette responded that the policy has several layers. No one carrier faces exposure for all risks or all levels of risk.

Regent Hime expressed concern about the fiscal ability of companies to cover significant payouts, and the possibility that, because multiple companies are involved, individual companies would try to avoid meeting their obligations. Ms. Crickette responded that the policy coverage is layered; the companies providing coverage are not "side by side." The "burning layer" of coverage is provided by Aspen. The University's insurance carriers are all rated "A" or above.

Regent Makarechian referred to the conditions of coverage listed in the background material and expressed concern about the University's ability to meet these conditions. Ms. Crickette responded that coverage is not conditioned on all systems being in compliance. Once a breach occurs, a forensic review takes place. If the review finds that UC adhered to best practices, the claim is covered. These conditions of coverage are best practices outlined in greater detail in UC's Business and Finance Bulletin IS-3. She noted that, even if all these best practices were in place, the University would still be vulnerable to cyber attack. There would be a positive inducement for campuses to meet UC policy standards and follow best practices in order to receive this insurance coverage.

Regent Makarechian expressed concern that some individuals within the University might infer that, because they have this coverage, they do not need to follow best practices. He also expressed concern that the insurance carriers could find many reasons for denying coverage. General Counsel Robinson responded that the University is not in a worse situation with the new coverage, other than the $500,000 cost; he concurred that the coverage is a positive inducement to improve UC processes. Mr. Taylor added that the University wishes to incentivize campus leadership to follow best practices and the coverage is considered a way to accomplish this. Associate Vice President and Chief Information Officer Ernst observed that single information security breaches have cost the University more than $500,000. Ms. Crickette cited the University's purchasing power and its reputation in the insurance marketplace and stated that insurance carriers would be unlikely to deny coverage entirely. The University is in the best possible situation for an insured entity in this market. This insurance coverage is being used to promote improvement in UC practices.

Regent Zettel noted that ensuring employee compliance with best practices is difficult. She asked about compliance training and how compliance on campuses can be measured. Mr. Ernst responded that an information security training program, focused specifically on this goal, would be available by the end of the calendar year. He observed that human error is the most significant cause of security breaches.

Regent Zettel observed that employees in other State agencies must sign a statement to the effect that they are familiar with information security policies. Mr. Ernst responded that UC employees would have to complete the information security training program, not simply sign a statement.

Committee Chair Ruiz asked about the deductible for the new policy. Ms. Crickette responded that the deductible is $1 million. There is $2 million in coverage. The University's general liability policy covers up from this amount to $100 million.

Committee Chair Ruiz observed that there may be new governmental guidelines regarding penalties for organizations when information security breaches occur. He asked about the nature of this risk and noted that, although the new insurance policy may have flaws, it might be more costly to the University not to have such a policy. Mr. Taylor responded that the University's exposure in certain cases has been enormous. Ms. Crickette noted that in one case, covered by the University's general liability program, the defense reserves are $1.5 million. The University has spent $670,000 on defense in this case; under the worst case scenario, the University would experience a $230 million loss. Mr. Robinson recalled that State law provides for nominal damages of $1,000 per individual in information security breaches. In the case of a database with information on one million individuals, there is a potential cost of $1 billion.

In response to a question by Regent Makarechian, Ms. Crickette responded that the new policy covers fines for information security breaches.

Regent Makarechian questioned the purpose of the $2 million coverage of the new policy if general liability insurance is already in place. Ms. Crickette responded that the general liability coverage is limited; it is still open to question whether general liability insurance will cover information security breach fines. In the past, the University's general liability program has denied breach fines, although it has helped pay defense costs. She emphasized that defense costs are significant.

Regent Makarechian questioned the value of paying $500,000 for a policy which would cover only up to $2 million. Ms. Crickette clarified that the coverage, $2 million per year, is the greatest coverage the University was able to purchase, due to its risk. Greater insurance coverage would become available to the University as it demonstrates that it is making improvements. Mr. Taylor anticipated that, as the University improves its best practices, the market would soften and UC could purchase additional coverage.

Committee Chair Ruiz observed that cyber insurance is a new field and that insurance companies are proceeding cautiously. He asked that the Committee receive periodic updates on developments in cyber insurance and on how UC is improving its practices and coverage.

Ms. Vacca emphasized that a collaborative effort, including campus leadership, would be necessary to improve best practices. Ms. Crickette stated that the University would receive feedback from campus chief information officers on whether the new policy has facilitated positive changes. The situation would be monitored over the coming year.

Committee Chair Ruiz asked if the University could request that certain vendors also acquire cyber insurance. Mr. Robinson stated that the University likely has indemnification provisions, but that the magnitude of the risk is large for most vendors.

6. **UPDATE ON COMPLIANCE AND AUDIT ISSUES RELATED TO PRIVACY**

[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.]

Systemwide Privacy Officer Russell Opland began his presentation by noting that in 2003, under the Health Insurance Portability and Accountability Act (HIPAA), a privacy rule went into effect for UC medical centers. In 2005, an information security rule went into effect for the medical centers. In 2009, under the American Recovery and Reinvestment Act (ARRA) and the Health Information Technology for Economic and Clinical Health (HITECH) Act, revisions were made to those privacy and security rules, one of which expanded HIPAA coverage to include some UC vendors.

As the result of changes at the federal level, the University undertook a comprehensive effort to review and update its systemwide HIPAA policies the previous year. Those revisions have been completed with the assistance of the Office of the General Counsel and of campus HIPAA officers. The University's revised HIPAA policies would be implemented systemwide during the coming fiscal year.

The review determined the need to clarify which areas of the UC system are subject to the privacy and security rules. These HIPAA rules concern primarily health care providers who conduct electronic transactions. Mr. Opland described this as an opportunity to delineate these areas of UC and to reduce the University's regulatory risk exposure. One challenging aspect of this analysis is the possible effect it could have on human subject research. The University is taking a cautious and considered approach, engaging with faculty to ensure that these research activities are not negatively affected. Work on this issue would continue in the coming months.

Mr. Opland briefly outlined current collection and analysis of HIPAA metrics and collaboration with the department of Information Resources and Communications on privacy and information security governance issues. In its effort to leverage systemwide efficiencies, the University is examining business contracts with vendors where UC might have exposure. Under HIPAA, the University is required to enter into contractual arrangements with certain vendors to ensure the security of patient information. In addition, the University has a contractual appendix regarding data security for contracts which are not subject to HIPAA privacy and security requirements.

The University monitors legislative and regulatory developments at the federal and State levels. Mr. Opland informed the Committee that a notice of proposed rulemaking has been issued in conjunction with the HITECH Act. The Office of Ethics, Compliance and Audit Services works with other departments at the Office of the President and with systemwide representatives in presenting the University's position on notices of proposed rulemaking and in responding to solicitations for comments by the federal government.

7. UPDATE ON TECHNOLOGY AND SECURITY

Associate Vice President and Chief Information Officer Ernst provided an update on information technology and security at UC, reporting progress in a number of areas.

Mr. Ernst first discussed compliance audits concerning UC security policy. He recalled that campus self-assessments had taken place over the previous three years, and that the Committee had expressed interest in an actual audit of this area. He announced that an internal audit would take place, campus by campus, between March and June 2011.

Earlier in the year, President Yudof requested that the chancellors conduct a review of Social Security number protection on the campuses. The reviews were completed in June and they showed that, while there is strong appreciation everywhere for the need to protect Social Security information, there is significant variation among the locations in the approaches used. The University's next step would be to identify the best practices currently in place and to disseminate them systemwide.

Mr. Ernst reported that a work group of experts was examining online security awareness training programs available from private industry as well as campus programs in order to develop a UC information security and privacy training and awareness program, to be implemented by the fall. The program would be disseminated first to employees who have access to confidential information. It would be tested to ensure its efficacy. Mr. Ernst anticipated that it would be fully functional by early 2011. It would include a certification process to enable monitoring of course completion by employees. These data could then be examined to determine if training had reduced the number of breaches attributable to human error.

President Yudof has organized a steering committee to examine privacy and security issues. This committee would not only examine policy, but would also identify the principles that should guide a university like UC in addressing privacy protection and in implementing current technologies. Mr. Ernst anticipated that this committee would have a report and recommendations within 12 to 18 months.

At their July meeting, the Regents adopted the Resolution Regarding Administrative Efficiencies. The Resolution expressed the need for greater collaboration, something desired by many campuses, and it emphasized the importance of this matter to those who may have been indifferent to efforts to develop common systems. The UC Information Technology Leadership Council (ITLC), which includes campus and medical center chief information officers, has agreed to provide a set of recommendations, seeking especially to identify those applications most amenable to collaborative approaches.

The Regents' Resolution also provided added impetus for the development of a UC strategic plan for information technology. Mr. Ernst anticipated that an implementation plan would be developed by mid- to late spring 2011, including timelines, cost-benefit analysis, business case analysis, and expected outcomes.

Finally, Mr. Ernst reported on the regional data center project, which was already under way before the Resolution. The University was establishing its first regional data center at UC San Diego, using available space at the San Diego Supercomputer Center. Campuses were currently moving servers to the San Diego site; this would enhance security, lower costs, and free up space on the campuses.

Faculty Representative Simmons urged the University, as it protects information and maintains secure systems, to consider the additional cost or restraint it may impose on the accomplishment of work. He noted that faculty, especially medical school faculty, may feel burdened by compliance training requirements. He cautioned against the overdevelopment of compliance requirements.

Committee Chair Ruiz agreed with Mr. Simmons and observed that businesses face the same challenge. As the University develops new systems and new ways of doing business, it must address compliance and security. The University must not waste employees' time, but employees must be aware of these issues.

8. **PROPOSED GOVERNMENTAL ACCOUNTING STANDARDS BOARD CHANGES**

[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 Financial Officer Taylor called attention to a July 7, 2010 memorandum he drafted to Committee Chair Ruiz and Regent Zettel about proposed Governmental Accounting Standards Board (GASB) changes to its standards regarding pension accounting and financial reporting by employers.

Associate Vice President and Systemwide Controller Peggy Arrivas outlined the four major proposed changes. GASB issued a "Preliminary Views" document in June 2010. The purpose of this document was to gather comments, and public hearings are scheduled in October. After receiving this feedback, GASB would consider issuing a draft standard for comment.

The first proposed change concerned unfunded liability. Currently the University discloses the amount of its unfunded liability in the footnotes to its financial statements, but not as a liability on the balance sheet. This change would move the liability to the University's balance sheet, a significant change to UC financial statements. As of July 1, 2009, UC's unfunded liability was $1.9 billion. In part because of market performance, this amount was increasing.

The second proposed change might require the University, to the extent that UC Retirement Plan (UCRP) assets are not sufficient to pay pension benefits that have been promised, to use a different discount rate. Currently the University discounts its liabilities at 7.5 percent, which is the University's investment rate. Because the University expects investment returns of 7.5 percent, it can justify discounting liability at this rate. Under the proposed change, if the UCRP ran out of assets, UC might have to use a lower municipal bond rate, which would raise liability significantly. If the University developed a funding plan to make assets available when they must be paid, it could continue to use the current higher discount rate. The University is examining pension recommendations designed to ensure UCRP funding. Mr. Taylor observed that the University must not only have a plan, but it must adhere to that plan. In the coming months a UCRP funding policy would be presented to the Regents; if approved, the University must adhere to this policy. The proposed GASB rule would affect the University if it did not adhere to its funding policy. Mr. Taylor noted that the University has submitted a comment on this rule to GASB. It has requested clarification of the definition of a high-grade municipal bond rate. The University has suggested that it should be a taxable high-grade municipal bond rate, not a tax-exempt rate. The proposed GASB rule does not differentiate the two.

Ms. Arrivas continued with the discussion of the third proposed change. Currently, UCRP expenses reported in the financial statements are based on UC's funding policy. Under the proposed change, the reported expenses would be based on period of service; UC would record its expenses based on employee service and on what pension benefits have been promised to employees. There would not be a clear linkage between funding and expense, as there has been in the past.

The fourth proposed change concerned calculation of asset values, including measurement of unfunded liability. A change in method was proposed.

Ms. Arrivas reported that Mr. Taylor submitted a comment letter to GASB the previous day. The University commented on three areas. The first comment was related to the proposed use of a high-grade municipal bond rate, mentioned earlier. The second area was volatility. UCRP expense assumption changes, used to estimate the UCRP liability, would be recognized based upon remaining employee service periods. Under the GASB proposal, if employees have vested benefits and have terminated their employment, the expense related to the assumption changes for this group must be reported immediately, because there is no remaining service period. This change would cause significant fluctuations in pension expenses from year to year and would probably make the financial statements confusing; therefore, the University has asked that GASB reconsider its preliminary view on the amortization period for changes in assumptions. The third area was the market value approach suggested by GASB; the University's actuaries believe that this approach is not favored by the actuarial profession. The University is suggesting that GASB reconsider this proposed method for valuing assets.

Regent Makarechian asked about the reporting guidelines for the unfunded liability. Ms. Arrivas responded that the GASB proposal would require that the liability be recorded in the financial statements and that the change in the liability would be expensed or smoothed over a period of several years, depending on the final standards.

Regent Makarechian asked if it is possible, when the liability is expensed over this period, to distribute expenses such that some costs could be reimbursed by the federal government. Ms. Arrivas responded in the affirmative. To the extent that the University is expensing contributions required under its funding policy, it charges these expenses to contracts and grants. The contract language governs what is reimbursed.

Regent Makarechian suggested that the University might benefit from this change in GASB standards. Mr. Taylor responded that approximately 7.5 percent of the University's covered compensation comes from federal contracts and grants. The University believes that it is in a position to recover some previous losses from investment returns for that portion of its covered compensation related to federal contracts and grants. It cannot recover underfunding from the 19-year period when no UCRP contributions were made. Mr. Taylor observed that the federal government would reimburse UC provided the University pay its fair share for the remaining non-federal part of its covered compensation. The University was seriously examining this matter.

Regent Makarechian asked if the proposed changes would affect the University's bond rating. Mr. Taylor responded that he has discussed this matter with rating agency representatives. If rating agencies incorporate these changes in their review of the University, they must do so for all government sector entities. The UCRP is in a better position than many defined benefit plans. Rating agencies are moving slowly to update their procedures. Mr. Taylor did not anticipate any immediate impact on the University's rating, but there would be some change over time. Ms. Arrivas added that, from discussions with actuaries, the University did not anticipate implementation of these changes before 2013. GASB would solicit feedback in October, and then could issue a draft of the proposed standard. The draft would be available for comment, and then GASB would issue a final standard with future required implementation dates. Implementation would take a few years; during this time the University could follow a new UCRP funding policy before it would have to adopt the GASB changes.

Regent Makarechian referred to the fourth proposed change discussed in the July 7, 2010 memorandum, concerning calculation of asset values, and requested clarification of the 15 percent difference between market and actuarial value. Ms. Arrivas explained that there is a 15 percent market value "corridor" for UCRP assets; if assets remain within this 15 percent corridor, the difference would not be adjusted. In any year that UCRP assets differ more than 15 percent from their actuarial value, the difference would have to be recognized immediately.

Regent Makarechian asked how often this might have occurred over the past 20 years. Ms. Arrivas stated that UCRP assets were outside this corridor two years previously, when the market was down. Under the proposed GASB change, this would have represented a significant expense for the University. Currently, the unfunded liability, expected to grow to $9 billion, is being amortized over a period of years. The proposed GASB change would not allow this kind of amortization.

Committee Chair Ruiz noted that the Committee on Finance is also considering these matters. Mr. Taylor stated his wish that the Committee be aware that the University is keeping abreast of GASB developments. From the perspective of the private sector, GASB was now catching up with Financial Accounting Standards Board (FASB) rules which had been in place for decades. The Committee must be informed of possible changes which could have an enormous impact on the University's financial statements.

The meeting adjourned at 4:50 p.m.

Attest:

Secretary and Chief of Staff