The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
November 7, 2011

The Committee on Compliance and Audit met on the above date by teleconference at the following locations: 1111 Franklin Street, Room 11326, Oakland; West Coast Room, Covel Commons, Los Angeles campus; 3104 Mosher Alumni House, Santa Barbara campus.

Members Present: Regents Crane, Makarechian, Mireles, Pelliccioni, and Zettel; Advisory member Anderson; Expert Compliance Advisor Guyton and Expert Financial Advisor Edrick; Staff Advisor Herbert

In attendance: Faculty Representative Powell, Secretary and Chief of Staff Kelman, Associate Secretary Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Chief Financial Officer Taylor, and Recording Secretary Johns

The meeting convened at 2:45 p.m. with Committee Chair Zettel presiding.

1. **PUBLIC COMMENT**

Committee Chair Zettel 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. Jerry Rubenstein stated that he represented a campus organization called “Bruins for Privatization.” He expressed support for greater privatization at UC and for free market principles.

B. Ms. Cheryl Deutsch, president of United Auto Workers (UAW) Local 2865, which represents UC student employees, read a letter from the ReFund California coalition. The letter advocated tax system reform and called on all segments of society, including wealthy citizens and large corporations, to pay a fair share to support public education.

C. Ms. CedarBough Saeji, a first-generation college student, described her financial struggles as a graduate student at UC, and how they affect the quality of her academic work. She urged the Regents to consider the impact their decisions have on students and to provide increased funding for student and faculty needs.

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

Upon motion duly made and seconded, the minutes of the meeting of September 13, 2011 were approved, Regents Crane, Makarechian, Mireles, Pelliccioni, and Zettel (5) voting "aye."[1]

3. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2011**

[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, 2011. The audit documents included the Required Communications to The Regents' Committee on Compliance and Audit and the Report to the Regents' Committee on Compliance and Audit. The Report contains internal control recommendations. The PwC audit was conducted by 14 teams at various UC locations. PwC revised its audit approach this year in some areas, with additional detail testing. Ms. Murphy praised UC employees' cooperation with PwC on the audit work.

Regent Makarechian referred to the Required Communications to The Regents' Committee on Compliance and Audit. He asked about reclassifications to the 2010 financial statements. One reclassification was a decrease in investment derivatives and an increase in fixed or variable income securities. Associate Vice President and Systemwide Controller Peggy Arrivas responded that this reclassification was related to mortgage-backed securities the University purchases in advance of their issuance. In the previous year's financial statements, the University considered these securities derivatives. Following Governmental Accounting Standards Board (GASB) guidance this year, these securities were reported in the investment portfolio; they could not be considered derivatives. Ms. Arrivas noted that this reclassification had no effect on the UC medical centers because the medical centers do not own any of these securities.

Regent Makarechian asked about another reclassification, a $175 million revision of reported cash flows. Ms. Arrivas responded that previously, the University reported changes in its cash flow statements for some accounts as net amounts, but that these should have been reported as gross amounts. This was the case for accounts receivable and the allowance for doubtful accounts, accounts that the University anticipates will be uncollectible. This change in cash flow statements was made in the current-year financial statements. In response to another question by Regent Makarechian, Ms. Arrivas confirmed that this would not change the University's reserves.

Regent Makarechian asked how materiality thresholds are determined. Ms. Murphy responded that because PwC cannot audit every transaction, the audit is based on the

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

concept of materiality. Different materiality thresholds are used for different reporting entities; the materiality thresholds for the University are different from those used for a for-profit company. For the UC benefit plans, such as the UC Retirement Plan (UCRP), the materiality threshold is one percent of net assets. Ms. Murphy observed that PwC uses lower thresholds to drive the audit and to determine which adjustments it would propose. For the University, the overall materiality threshold of $242 million is based on a percentage of UC expenses. Five percent of this amount, or $12 million, is the threshold for proposed audit adjustments. Ms. Murphy reminded the Committee that for PwC, amounts below these thresholds are not material to the overall financial statements and would not affect decision-making based on those financial statements.

Regent Makarechian requested clarification of the definition of UC expenses, as used to determine the University's materiality threshold. Ms. Murphy responded that the $242 million amount is equal to one percent of total annual UC operating expenses. For the medical centers, the threshold is equal to 1.5 percent of total annual operating revenues.

Regent Makarechian asked about the determination of capital leases. Ms. Arrivas responded that the University provides guidelines for the campuses and medical centers for determining which leases are capital leases. In its audit, PwC reviews UC management's determination of capital leases. Ms. Murphy added that PwC refers to the technical literature in this matter, and expects UC management to present a summary of technical guidance supporting UC's proposed accounting. PwC leasing experts sometimes participate in this review. In response to another question by Regent Makarechian, Ms. Murphy responded that PwC has not had disagreements with UC management on this issue, but that there has been a great deal of dialogue. The University generally discusses this issue with PwC before entering into a lease transaction.

Regent Makarechian recalled that in July 2011, the University issued bonds to finance the University's contributions to the UCRP; however, the UCRP liability has remained at the same level. He asked how the issuance of bonds had affected the accounting for this liability. Ms. Arrivas responded that this transaction occurred in July 2011, after the June 30, 2011 financial statements were issued. The transaction would be reflected in the next year's financial statements; it would reduce the University's UCRP liability and increase its general revenue bond liability. Ms. Arrivas acknowledged that this was a shift from one liability to another, but pointed out that the borrowing costs for general revenue bonds are significantly lower than those for the UCRP, so this shift would result in savings for the University. Chief Financial Officer Taylor recalled that these bonds were issued in order to secure current low interest rates for several years and to reduce the overall UCRP employer contribution cost. This transaction allowed the University to meet the UCRP normal cost and the interest on unfunded liability in the current fiscal year, and it is expected to save campuses and medical centers over one percent on the UCRP employer contribution in the future. Mr. Taylor explained that the transaction was a shift from a "soft" liability to a "hard" liability. Bonds are a hard liability and must be paid on time, while there is some flexibility in the timing of payment for pension liabilities. The University believed it was prudent to move to a hard liability in order to reduce long-term costs. In fiscal year 2010-11, the University transferred $1.1 billion from the Short Term Investment Pool (STIP) to UCRP. This transfer and the issuance of bonds have added almost $2.1 billion into the University's retirement system. Mr. Taylor anticipated that these actions would help stabilize the UCRP.

Regent Makarechian noted that that the UCRP would come closer to being balanced, but the University's debt would increase. He asked if this was desirable, given the State's failure to pay its UCRP obligation. Mr. Taylor responded that UC issued the bonds as floating rate bonds. If the State pays its UCRP obligation in the future, the University has complete flexibility to use those funds to pay down the State's portion of the outstanding debt.

Regent Makarechian expressed concern that what had been a potential liability for the University may have become a real liability, and that the State would not be held accountable for its UCRP obligation. Mr. Taylor responded that while the University wishes to have the State as a partner in funding the UCRP, the University is ultimately held responsible for this funding. If the University can negotiate with the State for contributions to the UCRP, it would have the flexibility to apply those funds to repay debt.

Regent Makarechian referred to the $353 million listed in the Required Communications as the amount of reserves for bad debts. He requested a breakdown of this amount. Mr. Taylor responded that this breakdown would be provided.

Regent Makarechian asked about the $705 million accounting estimate for fair value of mortgage loans. Mr. Taylor responded that this amount was the face value, the principal amount of University-issued mortgages as of June 30, 2011. Ms. Murphy confirmed that this figure represented the net realized value of the mortgage loans.

Regent Makarechian asked if the University estimates the fair market value of these loans. Mr. Taylor responded that UC does not estimate this amount for audit purposes, but does track this information internally. Like any home lender, the University wishes to know its position in regard to the reserves it has in place.

Regent Makarechian noted that PwC provided internal control comments in separate management letters to the campuses. He asked that these management letters be included in the report, so that Regents would be aware of campus issues. Mr. Taylor and Ms. Arrivas responded the management letters would be provided.

Referring to Regent Makarechian's earlier question about the $353 million amount of reserves for bad debts, Ms. Arrivas drew attention to a summary of accounts receivable in the 2010-11 Annual Financial Report. The allowance for doubtful accounts was listed as approximately $326 million; the largest part of this allowance was for the medical centers. A summary of pledges receivable in the same report included an allowance for uncollectible pledges; this allowance and the allowance for doubtful accounts together made up the $353 million total.

Regent Makarechian asked about the use of the allowance for doubtful accounts. Ms. Arrivas responded that, among other purposes, this allowance covers situations in which patients are not able to pay for services or when insurance companies deny payment.

Regent Crane asked if there had been any changes to the rules for determining whether a lease is a capital or an operating lease. Ms. Arrivas responded that the rules have not changed, but noted that the University carries out fairly complex transactions, such as public-private partnerships involving a developer and a third party. In these cases the University discusses lease issues with PwC at an early stage. Ms. Murphy observed that the significant issues in these cases concern the parties to the lease and their relationship to the University.

Regent Crane asked if the distinction between capital and operating leases was important for bond markets. Mr. Taylor responded in the affirmative and added that rating agencies also take this into account. Ms. Arrivas noted that lease revenue bonds issued by the California State Public Works Board are reported as capital leases in the University's financial statements. Mr. Taylor indicated that the University has regular discussions with rating agencies about this matter. The University considers these bonds to be State debt, because the State budgets for the debt service and manages the sale. The University receives the proceeds and builds the projects approved by the Legislature; it does not consider this to be University debt.

Regent Crane suggested that the University's annual financial report include a graphic, visual chart illustrating the change in the composition of UC revenues over time. Such a graphic would show clearly the dramatic decline in State funding.

Regent Crane referred to a balance sheet in the 2010-11 Annual Financial Report which showed that the University's obligations for retiree health benefits had increased to approximately $5.2 billion from $3.7 billion the previous year. He compared these figures to a chart of required supplementary information in the same report which included much higher figures. Ms. Arrivas responded that the University's total unfunded liability for retiree health costs is $15.4 billion. Under current standards, the University is not required to report the entire liability on its balance sheet; instead, a portion of the liability is amortized each year. In response to another question by Regent Crane, Ms. Arrivas confirmed that GASB Statement 45 allows this amortization. The full liability would be phased in over a period of 30 years.

Faculty Representative Anderson asked if the amount added each year is the difference between the Annual Required Contribution (ARC) and the amount actually contributed. Ms. Arrivas responded that the University funds retiree health benefits only on a "pay as you go" basis. The amount is equivalent to the ARC. Ms. Murphy added that pension accounting follows a similar procedure under GASB. Ms. Arrivas noted that GASB has put out a proposed standard for comment. Under this standard, the entire pension liability would be reported on the University's balance sheet. From its discussions with GASB, the University has learned that GASB intends to propose a similar standard for retiree health cost accounting. GASB plans to issue the pension accounting standard in summer 2012 with an effective date for UC in summer 2013.

Regent Crane asked about the current-year difference between the “pay as you go” costs and actuarial accrued liabilities for retiree health benefits. Ms. Arrivas referred to a chart in the 2010-11 Annual Financial Report which showed that UC cash payments to the UC Retiree Health Benefit Trust were approximately $288 million in the current year and $260 million in the previous year. The actuarial accrued liabilities shown in the report were approximately $1.7 billion in 2011 and $1.6 billion in 2010.

In response to another question by Regent Crane, Ms. Arrivas confirmed that the difference between the cash payment and the actuarial accrued liability is added to the balance and accrues interest.

Committee Chair Zettel referred to the financial statements for the UC medical centers and noted that the UC Davis Medical Center is eligible for $39 million in grant funding through the Children’s Hospital Bond Act of 2008. The UCD Medical Center had so far not received any grant funding, although it is undertaking an expansion of the UC Davis Cancer Center, which includes a pediatric cancer program. Ms. Arrivas responded that the University receives this grant funding on a reimbursement basis; it must first spend the funds and then seek reimbursement from the State. The State does not always have funds available for reimbursement, and for this reason reimbursements in 2010 were deferred. Some UC medical centers have received reimbursements, but this has involved waiting in a queue. Mr. Taylor added that the State had issued approximately $2 billion in general obligation bonds in recent weeks. The University would inquire whether this bond issue would include Children’s Hospital Bond Act grant funding.

Committee Chair Zettel asked why UC medical centers had not received incentives for implementation of electronic medical records. Ms. Arrivas recalled that federal government criteria for this incentive program were issued in mid-2010. UC San Diego recently submitted an application for the incentive program, and other UC medical centers were now preparing their applications.

Committee Chair Zettel referred to a section of the Required Communications concerning significant or unusual transactions, which included payments received by the UC medical centers from the State’s Hospital Fee Program. She asked if incentive payments to medical center employees would be based on this revenue, rather than on revenue derived from operational efficiencies. Ms. Arrivas responded that UC medical centers received a total of approximately $229 million from the Hospital Fee Program. Some of this revenue was reported as patient service revenue; $143 million was reported as non-operating revenue. An increase in operating revenue would be reflected in employee incentive payments, so that a portion of the Hospital Fee Program revenue would contribute to employee incentives.

Committee Chair Zettel noted that in the current environment of health care reform, there were efforts to move away from fee for service funding, the current model for Medi-Cal and Medicare. She asked if the University was considering the financial effects on UC medical centers of a possible transition from fee for service to capitation programs. Ms. Arrivas responded that UC medical centers were studying the possible impact of Medicare reform and developing revenue projections, working closely with the Division of Health Sciences and Services at the Office of the President.

Regent Makarechian referred to student enrollment numbers listed in the 2010-11 Annual Financial Report. He noted that undergraduate student enrollment grew by about 16,000 students between 2007 and 2011, while the cost of instruction rose significantly, from approximately $3.5 billion to $4.9 billion during the same period. He asked why the cost of instruction had risen so much relative to other budget line items. Mr. Taylor responded that one of the key drivers of the cost of instruction was the fact that under GASB Statement 45, UC was now accounting for the cost of pension and other post-employment benefits for instructional staff, not only salary. In 2007 UC did not have to account for this cost, but in 2008 this changed and there was a significant increase from $3.5 billion to $4.126 billion. Ms. Arrivas confirmed that this was the first year when post-employment health benefits were included in the calculation of the cost of instruction. The pension component was included for the first time in 2010.

Regent Makarechian commented on the increase in revenue from tuition and fees relative to the increase in student financial aid, as shown in the summary chart in the 2010-11 Annual Financial Report. He asked about return to aid. Mr. Anderson and Mr. Taylor explained that approximately one-third of the net increase in tuition is returned to aid, not one-third of all tuition revenues. Regent Makarechian suggested that the Annual Financial Report include a footnote or notes explaining this circumstance.

4. **CHIEF FINANCIAL OFFICER DIVISION AIM REPORT: ACTIONABLE INFORMATION FOR MANAGERS**

[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 his division had begun a project the previous year to benchmark administrative performance on the campuses. He drew attention to recent successes described in the current AIM Report. The University has been making efforts to encourage employees to receive their W-2 forms electronically. E-mail reminders were sent to employees, and in the first ten months about 6,000 employees signed up. The University then installed a “pop-up box” reminder that appears when employees view their earnings statements online and that prompts them to sign up for an electronic W-2 form. Approximately 7,000 employees signed up within a week. This measure reduces printing and mailing costs.

Mr. Taylor explained that another goal for the University is to increase the percentage of campus purchasing made through strategically sourced contracts to 80 percent. The medical centers have exceeded this goal, and campuses are working toward it. The University is also seeking to increase the percentage of transactions processed electronically. Mr. Taylor anticipated that in the future, a standard financial system for the University would facilitate electronic transactions. Currently there was variation among the medical centers and campuses in the percentages of their electronic transactions. The comparative data in the AIM Report would help the locations learn from one another and help the Office of the President to facilitate this learning. The AIM Report is updated quarterly and shared with the campuses.

Committee Chair Zettel praised these endeavors for the financial savings they provide and for promoting environmentally sustainable practices. She expressed surprise at what she described as a tepid response by some campuses. Mr. Taylor responded that this effort is ongoing.

Regent Pelliccioni referred to report data on efficiency gains through use of purchase cards. She noted that the results for two locations were particularly low. Mr. Taylor responded that these two locations have stated a preference for strategically sourced contracts rather than purchase cards. The Chief Financial Officer Division regularly discusses this matter with the locations. Regent Pelliccioni asked if this use of strategically sourced contracts was as transparent as the use of purchase cards would be. Mr. Taylor responded in the affirmative.

5. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2010-11**

[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 presented the Annual Report on Internal Audit Activities for 2010-11. She stressed that the internal audit program identified no material deficiencies in UC internal controls and that UC management has worked cooperatively to address possible risks. Ms. Vacca briefly discussed the resources and effort devoted to audits, advisory services, and investigations. Hours in advisory services have decreased. Ms. Vacca observed that in an environment of limited resources, audits are necessary to ensure that basic controls are in place and the resolution of Management Corrective Actions would take longer.

Committee Chair Zettel observed that, in spite of resource constraints, the number of outstanding Management Corrective Actions had been reduced during the year. Ms. Vacca stated that there had been a focus on Management Corrective Actions. Committee Chair Zettel praised the internal audit program for completion of 96 percent of the audit plan for the year.

Regent Pelliccioni asked if the internal audit program continues to monitor situations which give rise to Management Corrective Action plans when these plans are not implemented within an appropriate time frame. Ms. Vacca responded that monitoring depends on the severity of the issue and the risk involved. The internal audit program would like to carry out continuous monitoring, but this would require more resources than are available.

6. **REPORT ON ETHICS AND COMPLIANCE ACTIVITIES**

[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.]

Deputy Compliance Officer Lynda Hilliard noted that this report was a quarterly update. The ethics and compliance program is working with campus ethics and compliance officers to produce more numerical data on outcomes. These data would show how incidents or litigation costs have decreased due to better compliance.

Committee Chair Zettel called attention to a paragraph in the report about royalty audits and requested more information. Chief Compliance and Audit Officer Vacca recalled that President Yudof had asked two years earlier that the Office of Ethics, Compliance and Audit Services (ECAS) devote attention to this area. ECAS worked with campus technology transfer and intellectual property experts to identify key areas. In two years, auditing for contractual compliance recovered approximately $2.5 million for the University. Ms. Vacca recognized the work done by the campuses on relevant legal issues and correction of contract language. In some cases the University was being underpaid due to vague contract language or because the University was not taking appropriate measures to hold a licensee accountable. Language for future contracts has been improved. Campuses are interested in this issue and are requesting more activity in this area.

In response to a question by Committee Chair Zettel, Ms. Vacca confirmed that the University is making efforts to collect payment for all underpaid royalties.

Faculty Representative Anderson asked how the University determines if a licensee is underreporting earnings, since companies typically do not publicly report revenues from a particular product. General Counsel Robinson and Ms. Vacca responded that the University has the right to audit licensees' revenue. This right is provided for in contracts. Ms. Vacca observed that in one case, the mere prospect of an audit was enough to motivate action by a licensee and to recover monies owed to the University.

The meeting adjourned at 3:55 p.m.

Attest:

Secretary and Chief of Staff