

The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT

October 31, 2012

The Committee on Compliance and Audit met on the above date by teleconference at the following locations: 1111 Franklin Street, Lobby 1, Oakland; Covell Commons, South Bay Room, Los Angeles campus; Henley Board Room, 3104 Mosher Alumni House, Santa Barbara campus.

Members Present: Regents De La Peña, Kieffer, Lozano, Makarechian, Mendelson, Ruiz, and Zettel; Advisory members Feingold and Powell; Staff Advisors Barton and Smith; Expert Compliance Advisor Guyton and Expert Financial Advisor Edrick

In attendance: Faculty Representative Jacob, 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 2:15 p.m. with Committee Chair Zettel presiding.

1. **PUBLIC COMMENT**

There were no speakers wishing to address the Committee.

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

Upon motion duly made and seconded, the minutes of the meeting of September 11, 2012 were approved, Regents De La Peña, Kieffer, Lozano, Makarechian, Mendelson, Ruiz, and Zettel (7) voting “aye.”¹

3. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2012**

[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.]

Associate Vice President and Systemwide Controller Peggy Arrivas recalled that since the previous year, the Committee had approved a combined form of the financial reports for the UC retirement plans. The current report displays financial information for each retirement plan in adjoining columns. The quality of disclosures had been improved.

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

PricewaterhouseCoopers (PwC) representative Joan Murphy pointed out that PwC rendered a separate opinion on each retirement plan, although these plans are presented together in one document. PwC did not aggregate the plans or determine the accuracy of reporting in aggregate. The auditing of these plans was carried out with the same degree of effort as in the past.

Ms. Murphy briefly introduced PwC representative Jim Henry, senior relationship partner. Mr. Henry explained that he oversees Ms. Murphy's work and ensures that the PwC team has the necessary support and resources to serve as the University's external auditors.

Ms. Murphy explained that 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 Required Communications document provides an overall sense of the audit and information on any unusual transactions or new accounting pronouncements. The past year was a typical year. A few new Governmental Accounting Standards Board (GASB) pronouncements were adopted, but without significant impact on UC's financial statements. PwC does not audit every transaction, but uses the concept of materiality and threshold amounts. The threshold amount for proposing audit adjustments was \$18 million for the University overall, with other thresholds for specific entities. She observed that UC management uses a very low threshold of \$1 million, and adjustments are recorded to ensure that statements are accurate and to minimize the risk of any problems with aggregation.

PwC proposed only one audit adjustment for the year, to increase the fair value of investments held in trust, which are investments that cover self-insurance reserves. PwC proposed an adjustment to increase the fair value by \$35 million.

During the year, management at the Office of the President focused on the consistency of medical center financial statements and identified several adjustments, so that the 2011 financial statements would display the corrected amounts. Ms. Murphy noted the rigor of this effort, which improved the quality of the financial statements. These changes were not significant or material, and they did not affect the PwC audit opinion.

Regent Makarechian asked how the \$8 million materiality threshold for the UC Retirement Savings Program had been determined. Ms. Murphy responded that as a standard PwC approach, the overall materiality for a benefit plan is calculated based on a percentage of net assets. In this case, PwC calculated one percent of net assets, then calculated five percent of that number, and arrived at \$8 million. This amount is the level at which PwC would have proposed an audit adjustment, not the level of overall materiality. The threshold for the UC Retirement Plan, \$21 million, is calculated in the same manner, based on the approximately \$16 billion in assets. The overall materiality threshold for the University, \$18 million, was calculated differently, based on a percentage of total expenses. PwC calculated 1.5 percent of total expenses and then calculated five percent of that number to arrive at \$18 million.

Ms. Murphy noted that the 2011 adjustments to the medical center financial statements did not give cause for any adjustments to the consolidated financial statements. The data in the consolidated financial statements are aggregated differently than in the stand-alone statements for the medical centers.

Regent Makarechian asked about materiality thresholds for the campus foundations' financial reports. Ms. Murphy responded that there is a separate audit for each campus foundation. The materiality threshold is based on a percentage of net assets for the foundation being audited. Even as a combined total, the campus foundations are not nearly as large as the holdings of the University; nevertheless, PwC applies a lower materiality threshold because each has an individual stand-alone audit opinion. When PwC issues an audit opinion on an independent set of financial statements, materiality for the audit is based on information for that independent entity.

Ms. Murphy called attention to the fact that there was an implied control deficiency or significant deficiency related to the adjustments to the medical center financial statements for the prior year. This situation was remediated by UC management, who identified the adjustments and corrected the statements in a timely manner. In response to a question by Regent Ruiz, Ms. Murphy explained that the situation would be different if PwC had discovered this deficiency; in this case, the client, the University, discovered the inaccuracy and corrected it.

Ms. Murphy stated that PwC had received excellent cooperation from all UC locations.

Committee Chair Zettel referred to the implementation of GASB Statement No. 63 and noted that there was a reclassification of \$47 million in the University's 2011 financial statements. She asked if this was a significant change. Ms. Murphy responded that under GASB, a new accounting pronouncement must be applied retroactively to the prior year. She described this particular GASB Statement as ethereal in concept; it reclassifies an asset as a deferred outflow, a change in category. Ms. Arrivas added that the University had properly accounted for this amount, but was required to present the amount differently under the new rule.

PwC representative Jaime Jones discussed a second audit document, the Report to the Regents' Committee on Compliance and Audit. She explained that PwC does not opine on UC's internal controls over financial reporting, but does take them into consideration as part of its audit procedures and provides comments on any issues it feels should be brought to the attention of the Regents. PwC had two comments in the current Report. One comment concerned access controls for information technology. PwC noted 21 findings in this area during the year, of which nine were recurring and 12 were new. The findings were related to lack of documentation or review of access controls, which Ms. Jones attributed to transition in systems or staff. Ms. Murphy observed that the University faces many challenges related to information technology systems. As an auditor, PwC focuses on access to data and the integrity of data in financial statements. Every UC location has policies concerning access to data and data security, but the

University must devote time and resources to ensure that every location can comply with these policies.

Committee Chair Zettel asked how issues regarding information security and Health Insurance Portability and Accountability Act (HIPAA) compliance were being resolved at the medical centers. Ms. Murphy responded that PwC did not focus on access to patient data, but on financial statement data. If PwC had any observations in this area, it would share them. Chief Compliance and Audit Officer Vacca observed that the UC internal audit program focuses on data privacy and HIPAA-related concerns.

Ms. Jones then reported that PwC's second comment in the Report concerned the timeliness of review of key reconciliations. This same comment had arisen in the past for different UC locations. For key accounts, reconciliation would be expected to be performed within a two- to three-month period. In these cases control procedures took longer than they should have, but PwC found no error in the reviews themselves.

Committee Chair Zettel thanked Expert Financial Advisor Edrick for his assistance in reviewing the audit data.

4. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2011-12**

[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 Audit Director Matthew Hicks discussed positive trends in the current-year report on internal audit activities. There was a net reduction in Management Corrective Actions (MCAs); the University closed 32 more MCAs than it opened. Internal audit productivity, calculated as time spent on project hours and audit support, increased from 85 to 86 percent. There was also a reduction in the number of past-due MCAs compared to the previous year, from 481 to 428.

Chief Compliance and Audit Officer Vacca stressed that UC's internal audit program found no material deficiencies in the University's controls. Management is attentive to audit findings and seeks resolution. The audit program tries to ensure that issues are resolved in a timely manner and as completely as possible. She praised the work of UC's internal audit staff and stated that the University should be concerned about a succession plan for its internal audit leadership, as a number of internal audit directors would retire in the coming years, perhaps five or six in the next two years.

Regent Kieffer asked about succession planning currently under way or about succession opportunities. Ms. Vacca responded that this information would be provided.

Mr. Hicks discussed a chart comparing audit plan hours against actual audit hours and the hours for the prior year. The program was increasing the number of hours spent on advisory services. Another chart showed the trend in effort distribution by service type over a seven-year period, indicating a slight increase in the time spent on advisory

projects. Fuller completion of the audit plan had been achieved over the past three years. There was a general correlation between the percentages of MCAs by topic area and the percentages of audit hours spent on those areas, with some divergences. Ten percent of audit time was spent on information technology, while 20 percent of MCAs were in that area. Mr. Hicks observed that less transactional testing is needed to identify issues of concern in information technology than in other areas, such as financial management. Another anomaly was in the area of facilities and construction, with eight percent of audit hours and three percent of MCAs. This was due to a systemwide audit in this area during the year.

Committee Chair Zettel asked about reimbursements to the University for construction projects for which UC was overcharged and requested an approximate figure. She asked if the cases of overcharging were limited to a few campuses or to one particular campus. Mr. Hicks responded that this information would be provided; he estimated the figure to be approximately \$88,000 systemwide. Ms. Vacca added that the charges identified in these audits were often charges by subcontractors. These charges are difficult to track and control.

Committee Chair Zettel asked about the status of information technology security and access on the campuses. Mr. Hicks responded that there were several open MCAs on the campuses concerning access control. The internal audit program is working with management on the campuses and at the Office of the President to identify the most effective way to implement access monitoring. Ms. Vacca noted that the University now has a Chief Information Security and Privacy Officer and that a strategic plan regarding information security, and cybersecurity in particular, might be presented at a future meeting.

Regent Lozano requested information about the campuses' receptivity to the internal audit function and the campus-internal audit relationship. She asked how UC's manifold international activities would be included in the University's audit plan. Ms. Vacca responded that this information would be provided.

5. **CAMPUS VIEW: ANNUAL REPORT ON INTERNAL AUDIT 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.]

UCSF Audit Director Richard Catalano began his presentation by underscoring the uniqueness of the San Francisco campus, which is entirely devoted to the health sciences and to graduate education. UCSF includes an enormous clinical enterprise and an academic medical center with more than \$1 billion in research. The campus internal audit department has 11 full time equivalent staff positions. Mr. Catalano stated that the UCSF audit services department sees itself as a business partner with campus management. Cooperation with campus senior leadership is outstanding.

UCSF's current construction program includes a hospital project that is unique in its size and in its contracting model, a guaranteed maximum price contract. Under this model, the campus must continually monitor the accuracy of the rates being charged for labor. Mr. Catalano noted that he hired a construction auditor for this project who has helped to identify cost savings at an early stage, working with the hospital financial team.

UCSF audit services worked closely with campus management on the implementation of the medical center's electronic medical record system (Advanced Patient-Centered Excellence, or APeX), providing internal control advice. The audit department was able to provide input on system security as the system was being designed rather than after the fact.

As part of a systemwide audit focused on the requirements of the Health Insurance Portability and Accountability Act (HIPAA), UCSF audit services identified a number of concerns. One of them pertained to photocopiers and fax machines that have data storage. When hospitals remove this equipment, they must ensure that the data on these hard drives are wiped clean. UCSF audit services also carried out a web application security review on the campus in the past year and would carry out a similar audit in the current year at the medical center.

Like the other campuses, UCSF faces a challenging budget environment and is seeking ways to streamline its operations, reduce costs, and improve efficiencies. The campus has centralized its pre-award process for contracts and grants and its human resources operations, moving the latter from departments to service centers. Mr. Catalano observed that nevertheless, department-level controls are still of critical importance since most transactions take place at this level. Providing adequate audit coverage is challenging. He stated that the cooperative working relationship with campus leadership results in effective risk assessment and appropriate audit focus. Another challenge for audit services is recruiting staff with the appropriate skills for the unique setting of UCSF.

Mr. Catalano identified the use of data analytics and strong partnership with management as key strategies of UCSF's audit program.

Committee Chair Zettel asked about the need to enhance staff skills in response to new developments in information technology. Mr. Catalano responded that this function has been developed in house. The campus has provided financial support for in-depth training and classes in specific areas for audit staff. This approach has been successful, and the campus' Chief Information Officer, when asked about UCSF audit services' information technology capabilities, stated that the department has always been competent.

Committee Chair Zettel stressed the importance of this area as the University moves toward more centralized information technology systems. She asked if the health sciences campuses other than UCSF were aware of the issue of patient data stored in photocopiers and fax machines. Chief Compliance and Audit Officer Vacca responded that the issue had been raised two or three years earlier. At that time each campus took action to ensure that these data are properly destroyed when photocopiers are replaced, and to ensure that

data are protected while the machines are in use. Since then, this concern and the prevention of information security breaches in this area had received attention again at UC Irvine.

UC Santa Cruz Internal Audit Director Barry Long provided the perspective of an internal audit program on a small campus with about 17,000 students and 3,000 faculty, and an annual operating budget of approximately \$600 million. Compared to some universities across the U.S., UC Santa Cruz might be considered large, but it is small in relation to the other UC campuses. UCSC faces the same financial challenges as the other campuses. In the past four years there had been an approximately 30 percent reduction in funding for administrative functions. The audit program has a staff of 3.7 full time equivalent employees, even though in some cases its work may be as extensive as that on a large campus.

UCSC internal audit carries out four reviews annually in response to systemwide requests in areas such as construction and executive compensation. Another category of audits is risk-based reviews requested by management, with about six reviews annually. A third category of audits focuses on internal controls and transaction testing. Given the reduced audit staff, work must be done in an innovative manner, with more reliance on electronic data mining and data extraction than on transaction testing in person. UCSC's internal audit strategy includes close cooperation with campus risk assessment activities. The program aligns its services to meet campus strategic needs.

UCSC internal audit's efforts have led to a better understanding on campus of risks and mitigation. The previous year, the program performed a review of existing travel and expense policies. The review showed that the Santa Cruz campus treated many administrative functions rather conservatively; comparison with controls systemwide showed that some controls were superfluous, and they were removed. This produced savings in day-to-day operations. UCSC internal audit was able to provide assistance, particularly with financial analysis, to the UCSC Extension program to help make this entity profitable. In order to supplement its own resources, UCSC internal audit draws on resources provided by the Office of the President.

Regent Ruiz emphasized the importance of the role played by internal audit. He requested that the Office of Ethics, Compliance and Audit Services provide an annual report indicating the amount of savings produced by internal audit programs at the University, to monetize this performance. It would be helpful to capture information about areas such as construction where the internal audit program has saved money for the University. In an environment of pressure to reduce spending, this would demonstrate the value of the internal audit function.

6. **INTERNAL AUDIT QUALITY ASSURANCE REVIEW (QAR)**

[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 described this Quality Assurance Review as an “audit of the auditors.” The review would provide an independent validation of a self-assessment performed by the University’s internal audit program. Professional standards require this review every five years. She anticipated that the external team engaged to perform this review would present their findings at a future meeting.

Committee Chair Zettel pointed out that the members of the external team were high-level evaluators from Stanford and Duke Universities and a private firm.

7. **ETHICS AND COMPLIANCE ACTIVITIES REPORT**

[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.]

Committee Chair Zettel recalled Regent Lozano’s earlier question about the auditing of UC’s international activities. Chief Compliance and Audit Officer Vacca stated that the University is working on the development of a policy regarding UC activities abroad, a very complex area which includes concerns about the safety of UC-affiliated individuals and insurance of UC assets. UC has many different kinds of relationships with entities abroad, subsidiary and non-subsidiary. The draft policy documents were being reviewed by the campuses but had not yet been reviewed by the Academic Senate. Ms. Vacca noted that some controls were already in place concerning human safety, legal affairs, and financial operations.

Faculty Representative Powell described the University’s international activities as diverse, entrepreneurial, and opportunistic in a positive sense. Ms. Vacca stated that it would be challenging to develop a policy that would encourage innovation and entrepreneurship while mitigating significant risks.

Regent Ruiz asked about the management of UC’s international education programs. Mr. Powell responded that these programs are managed both at the systemwide and campus levels. While the systemwide Education Abroad Program is managed by the Office of the President, over the past decade, each campus has developed its own Education Abroad courses and programs, which are subdivided into academic year and summer programs. Some campuses even schedule overseas programs during the two-week intersession period. With regard to risk management and mitigation, the campus programs clearly must know when to turn to the Office of the President.

Ms. Vacca concluded that this was a complex area and that development of an appropriate policy would be challenging and take time. Regent Lozano expressed her agreement.

Deputy Compliance Officer Lynda Hilliard then discussed the report of ethics and compliance activities for the first quarter of fiscal year 2012-13. There was an increase in reporting of potential compliance concerns to the University’s confidential whistleblower hotline. There was a noticeable increase in the number of allegations of discrimination or

harassment, while the number of allegations of fraud, theft, and embezzlement had decreased. The Office of Ethics, Compliance and Audit Services has organized training sessions for campus employees on conducting on-site investigations.

An important ongoing effort is that by the Managing Youth Activities Workgroup to update UC policy on reporting child abuse and neglect to conform to recent changes in California law. These changes may broaden the categories of mandated reporters. The Office of Risk Services is providing resources to the campuses through the consultant Praesidium, Inc. to mitigate risks related to youth activities.

Ms. Hilliard then reported on a review of clinical research billing at the medical centers. She noted that there are complex rules governing the billing of patients who participate in clinical research studies. The University wishes to ensure that it is correctly billing the sponsor, Medicare, Medicaid, or federal or State programs. She distinguished this review from another project at the medical centers, an inventory of the billing and coding process, from a patient's scheduling and admission through to discharge and billing, to ensure that billing and quality of care are appropriate. She concluded with remarks on the status of the Policy Management System, currently under development, which would be used for review of UC Presidential policies.

Ms. Vacca announced that the 2013 Compliance and Audit Symposium for UC personnel would be held at locations in Northern and Southern California. She anticipated that there would be more than 400 participants at each site.

Regent De La Peña asked that there be coordination with the Committee on Health Services and Senior Vice President Stobo to ensure that there is no duplication of effort in the auditing of medical center research or of student health centers. Ms. Vacca responded that the results of the medical center review would be shared with Dr. Stobo and with the Committee on Health Services, if appropriate.

Regent De La Peña stated that these reports should be brought to the Committee on Health Services. Ms. Vacca responded that this information would be provided.

Committee Chair Zettel observed that UC research is increasingly carried out with private partners, such as pharmaceutical companies; the question of covering research costs was complex and would warrant discussion. The University must ensure that there is a fair process.

Committee Chair Zettel asked about the University's actions in cases when allegations of harassment or discrimination are substantiated. Ms. Vacca noted that whistleblower reports are often received when an individual has exhausted the avenues immediately available and when a problem has become acute. She confirmed that management takes action when a claim is substantiated, either through counseling, disciplinary action, or a termination.

Committee Chair Zettel asked what actions are taken when counseling is not effective. Ms. Vacca responded that it is the responsibility of UC management to ensure that there are ongoing controls. General Counsel Robinson added that frequently, incidents of harassment result in litigation and settlement. He noted that he reviews all proposed settlements. In instances where an investigation has substantiated allegations, he typically makes it a condition of his recommendation to the Regents that there be some kind of corrective action.

Committee Chair Zettel referred to youth activities. She asked if there was publicity, such as posters, on the campuses about the whistleblower hotline and about how to make confidential reports. Ms. Vacca responded that there would be more awareness of this issue on the campuses. The campuses are doing the best they can to make this information available, but Ms. Vacca stated that the University could do more in this area. Ms. Hilliard added that the campuses are taking this matter very seriously and taking steps to address it.

The meeting adjourned at 3:40 p.m.

Attest:

Secretary and Chief of Staff