The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
March 28, 2012

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

Members Present: Regents Makarechian, Mireles, Pelliccioni, Ruiz, and Zettel; Ex officio members Gould and Lansing; Advisory member Anderson; Staff Advisor Herbert

In attendance: Regents De La Peña, Hallett, Island, Kieffer, Lozano, Newsom, Pattiz, Reiss, Schilling, Varner, Wachter, and Yudof, Regents-designate Mendelson, Rubenstein, and Stein, Faculty Representative Powell, Secretary and Chief of Staff Kelman, Associate Secretary Shaw, Deputy General Counsel Birnbaum, Chief Investment Officer Berggren, Chief Compliance and Audit Officer Vacca, Provost Pitts, Executive Vice President Brostrom, Chief Financial Officer Taylor, Senior Vice Presidents Dooley and Stobo, Vice Presidents Allen-Diaz, Beckwith, Darling, Duckett, Lenz, and Sakaki, Chancellors Birgeneau, Block, Blumenthal, Desmond-Hellmann, Fox, Katehi, Leland, White, and Yang, and Recording Secretary Johns

The meeting convened at 9:45 a.m. with Committee Chair Zettel presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of November 7, 2011 were approved.

2. **APPROVAL OF THE SCOPE OF THE EXTERNAL AUDIT FOR THE YEAR ENDING JUNE 30, 2012**

The President recommended that the scope of the external audit of the University for the year ending June 30, 2012, which includes the following reports, be approved:

A. University of California system

B. Annual financial reports for each of the University of California Medical Centers

C. University of California Retirement Plan, including the PERS-VERIP Plan, University Retirement Savings Program, including the Defined Contribution, 403(b) and 457(b) Plans

D. National Collegiate Athletic Association (NCAA) audit procedures

E. Federal grants and contracts (A-133) audit

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

Committee Chair Zettel noted that this item had been fully discussed at a meeting of the Committee on February 28.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

3. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2012**

The President recommended that the external audit plan of the University for the year ending June 30, 2012, as shown in Attachment 1, and the fees shown in Attachments 2 and 3, be approved.

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

Committee Chair Zettel noted that this item had been fully discussed at a meeting of the Committee on February 28.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board.

4. **MANAGING COMPLIANCE RISKS: THE BOARD'S RESPONSIBILITY**

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

Chief Compliance and Audit Officer Vacca introduced Daniel Roach, Vice President of Compliance and Audit at Dignity Health, a recognized expert in compliance and board governance.

Mr. Roach began his presentation by stressing the importance for the Regents of understanding the compliance risks and challenges for an organization as large and complex as UC. The University is subject to the kind of legal scrutiny typical for any business organization, but it is also subject to far greater public scrutiny than most business organizations.

Mr. Roach identified the first challenge as underestimating the problem. There is a common misperception that most people will behave ethically on their own. While he expressed his wish that this were true, Mr. Roach stated that this is unfortunately not the case; rather, people will behave ethically in an environment with appropriate controls, with encouragement to behave appropriately, and where management sets a proper example. He illustrated this point with statistics. In a 2009 survey, 60 percent of high school students admitted to lying to a teacher; 32 percent admitted to stealing from a store in the past year. In 1963, 11 percent of college students admitted to cheating; by 1993, this figure had increased to 49 percent, and by 2007 to 75 percent. In 2007, 56 percent of M.B.A. students admitted to cheating; two-thirds thought that it was necessary or appropriate to cheat in order to be successful. The Association of Certified Fraud Examiners has determined that 90 percent of employees will steal from their employer, given motive and opportunity. The Society for Human Resource Management believes that 50 percent of resumes contain materially false information. These statistics should put management boards on alert and underscore the need for processes and systems to ensure that employees are behaving appropriately.

Mr. Roach drew attention to another challenge: compliance mechanisms developed with the best of intentions can fail or lead to undesirable outcomes. Based on his experience at Dignity Health, he observed that when managers are put under pressure to reduce overtime, they sometimes ask employees to work off the clock. If pressure is put on employees for productivity, they may act in ways that compromise patient care. The controls in place must be appropriate.

Ms. Vacca presented slides with lengthy lists of risks faced by the University and regulatory agencies interested in the University's activities. She emphasized that UC faces pressures from these agencies at the same time as it pursues its mission of teaching and research. She recalled the Regents' July 2008 resolution approving the UC Ethics and Compliance program. The program, which is independent of UC management, is intended to provide assurance to the President and Regents that compliance risks are being mitigated with appropriate controls. The structure of the program provides accountability and transparency. Each campus has a high-level, decision-making ethics and compliance committee. Information from the campuses flows to the President and UC senior management, and to the Regents.

Mr. Roach next discussed the proper role of the Board of Regents in this context. In his view, the Board's first responsibility is to understand risks; for this, it needs to receive constant communication from UC management about potential new risks and efforts to mitigate and control those risks. The Board must understand who is responsible for managing risk. A compliance officer is not responsible for compliance within an organization; this is the job of management. The Board must also define the scope of the University's compliance program. Mr. Roach stated that it is appropriate to delegate these responsibilities to the Committee on Compliance and Audit or another committee, as is the case in many organizations. The relevant committee must be given the opportunity to advise the Board on issues and must have the resources necessary to address these issues. The Board must approve key policies and procedures and ensure that processes are in place to protect the organization. The Board must ensure that incentives for employees are balanced with appropriate oversight and controls. In this context, Mr. Roach referred to a recent case of flawed medical research at Duke University. The Board must require relevant, periodic, and consistent substantive reporting by management on how it is implementing the University's enterprise risk management and compliance programs. When there are media reports of unfortunate events at other organizations and universities, the Board should ask UC management about its efforts to prevent this kind of event at UC. The Board must understand the differences between the compliance, internal audit, enterprise risk management, corporate social responsibility, and legal functions. They play complementary roles, but their activities and responsibilities are different. Mr. Roach cautioned that the presence of these functions does not by itself guarantee that risks are being appropriately managed. He noted the case of one company, Countrywide Financial, whose extensive enterprise risk management program was highly praised in 2007. About two years later Countrywide Financial experienced one of the most massive bankruptcies in U.S. history. Mr. Roach stressed the importance of ensuring that control processes are implemented appropriately, with specific, measurable objectives and internal transparency. The Board and the Committee on Compliance and Audit need to be involved in evaluation of the compliance, internal audit, and enterprise risk management functions, and ensure that problems are corrected.

Ms. Vacca stated that the University's compliance program enjoys strong support by campus and systemwide leadership. As the University becomes more complex, its compliance risks will need to be more closely integrated into its business decisions.

Regent Makarechian observed that the University's compliance efforts have an effect on its insurance rates for risk. He noted that if the University developed a captive insurance organization in house, in case of an incident and legal action against the University, this would represent a cost to UC alone. Ms. Vacca responded that risk would be minimized if strong controls and compliance efforts are in place.

In response to a question by Regent Makarechian, Ms. Vacca responded that the University's compliance program would remain the same, whether or not the University implemented a captive insurance organization. It would not change the program's focus on preventing, detecting, and deterring risk.

Regent Makarechian observed that some compliance procedures are required by outside insurance companies. He asked if any procedures would be eliminated if the University moved to an internal captive insurance organization. Chief Financial Officer Taylor responded that the University sometimes uses goals set by external insurance companies as a positive way of encouraging best practices within UC. He recalled that the University negotiates insurance rates systemwide, but allocates the internal costs differently among the campuses and medical centers. Those campuses and medical centers with good track records pay a lower rate. Mr. Taylor stated that the University would continue this practice, even if it pursues the development of an internal captive insurance organization. Compliance with best practices would result in lower costs for campuses and medical centers. Ms. Vacca stressed that the primary focus of the compliance program was on employee behavior rather than revenue. Chief Risk Officer Grace Crickette noted that a captive insurance company is regulated as much as any other insurance company.

Regent Makarechian observed that a captive insurance company would be limited by the amount of the University's capital. If appropriate procedures were not followed, the captive insurance company could be bankrupted quickly. Third-party insurers continually set new regulations. He suggested that this issue might be further discussed at a future meeting. Mr. Taylor responded that there would be further discussion. He noted that the University already uses self-insurance for four major categories of risk. One benefit of a captive insurance organization would be access to certain insurance programs that are currently prohibitively expensive or unavailable to the University. When best practices are implemented and a profit is generated for this insurance organization, under certain circumstances, the University could retain this profit.

Regent Ruiz emphasized the risk to the University if it did not maintain an effective compliance program, especially in the current difficult economic climate, and given the statistics cited earlier by Mr. Roach. He praised the compliance efforts of Ms. Vacca and the campuses.

Committee Chair Zettel stressed that a robust compliance and audit program would eliminate financial risks, protect the University's reputation, and protect the State's investment in the UC system.

Regent Pelliccioni underscored the importance of the information regarding the Board's liability presented in this discussion. She asked about the Board's potential liability if it fails to exercise due diligence and its appropriate roles and responsibilities. Mr. Roach responded that since about 2006 there has been an increasing potential for liability or personal exposure if a plaintiff or the government can show that the board of an organization neglected to perform its obligations – to remain informed, to ask management about its activities, and to hold management accountable for addressing problems.

The meeting adjourned at 10:15 a.m.

Attest:

Secretary and Chief of Staff

Audit Reports and Services

Audit Scope

PricewaterhouseCoopers has adopted a consistent approach for our audit procedures. We scope our work to perform an audit of the various financial statements. Overall we must achieve sufficient coverage to express an opinion on the University's consolidated financial statements as a result of our audit conducted in accordance with GAAS and GAS as well as on the individual Medical Center and employee benefit plan and related trust financial statements.

A-133 Reporting

Additional procedures are required for performing an audit of compliance with requirements applicable to each major federal program in accordance with GAS. At the time of preparing this report, we have identified two major programs (research and development and student financial aid) that will be subject to our OMB Circular A-133 audit for the year ending June 30, 2012. We expect that one or two additional programs requiring audit as part of the 2012 A133 work will be identified as part of the preparation of the 2012 Schedule of Expenditures and Federal Awards. Should additional major programs be identified that are required to be audited as part of the 2012 A-133 audit, we will alert the Committee of this.

PwC Services to the University

In addition to our audits, we provide advice on emerging accounting and reporting issues and provide certain other services including those listed below. Prior to commencing any services, we are required to obtain preapproval from the Committee or the Committee's designee pursuant to the University's preapproval policy for its independent auditor.

Audit Opinions	■ Report on the consolidated financial statements of the University of California ■ Reports on the financial statements of each of the five Medical Centers ■ Report on the University of California Retirement System ■ Reports in accordance with OMB Circular A-133, including: - Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards* - Compliance with Requirements That Could Have a Direct and Material Effect on Each Major Program and on Internal Control Over Compliance

Internal Control Observations	■ Report to the Committee on control and process deficiencies and observations, including material weaknesses and significant deficiencies (Regents Letter) ■ Reports to the campus Chancellors on control and process deficiencies and observations (Chancellor Letters)
Agreed-Upon Procedures	■ Agreed-upon Procedures related to the sale of Mortgage Origination Program and Supplemental Home Loan Program loans ■ Agreed-upon Procedures related to the 415(m) plans ■ Agreed-upon Procedures on Intercollegiate Athletic Departments (NCAA requirements) for six campuses
Other Services	■ Reviews in connection with bond offerings ■ Accounting consultations and other assistance associated with emerging accounting and reporting issues and complex transactions
Committee Reporting	■ Audit and communications plan ■ Results of audits and required communications

PricewaterhouseCoopers
Audit Fees

	Actual 2010	Actual 2011	2012
Core Audit, including expenses			
UC	$ 3,992,000	$ 3,619,000	$ 3,619,000
National Laboratories	69,400	62,000	62,000
	4,061,400	3,681,000 (2)	3,681,000
Required Scope Changes:			
Recurring - see detail below	50,000	-	(58,100) (1)
3.5% increase			126,800 (3)
Sub-total Core Audit Cost	4,111,400	3,681,000	3,749,700
Expanded Scope at the National Laboratory (Berkeley)	132,600	-	-
Total Audit Cost	$ 4,244,000	$ 3,681,000	$ 3,749,700

(1) Ongoing scope changes originating in each year are included in the Core Audit costs for the following year. They are:

Scope changes	2010	2011	2012
New GASB pronouncements	$ 50,000		
Changes in audit scope			(58,100) (4)
	$ 50,000	$ -	$ (58,100)

(2) For FY11 PwC has agreed to reduce fees by net of 10% over the FY10 fees. After applying the 5% fee increase originally approved by the Regents for FY11, fees were reduced by 15%, resulting in a net reduction of approximately 10% as compared to FY10.

(3) For FY12, UC agreed to increase the fees by 3.5% over the FY11 fees.

(4) Reduction in fee due to report changes made by University of California for the benefit plan reports. Additionally, the bond audit report is no longer required.

Attachment 3

PricewaterhouseCoopers
Audit and Consulting Fees [1]
2010 and 2011

Year	Core Audit	Other Audits	Audit Related	Consulting	Ratio of Consulting to Core Audit	Ratio of Consulting to Core Audit, other Audit and Audit Related Services
2010	4,111,400 [1]	920,509 [2]	896,659 [3]	160,738 [5]	4%	3%
2011	3,681,000 [1]	851,431 [2]	309,969 [4]	47,537 [5]	1%	1%

(1) Fees are generally allocated to the fiscal year under audit for audit services and to the year performed for consulting projects, if any. Ongoing scope changes originating in each year are included in the core audit costs for the following years.

(2) Primarily fees related to auditing the campus foundations and ASUCLA.

(3) Relates primarily to tax compliance, LBNL expanded procedures, UCSF compliance attestation engagement, West Village leasing consultation, UCSF MC IT cost review and UCI MC Eclipsys implementation assessment.

(4) Relates primarily to tax compliance, CFIA audits, and agreed upon procedures

(5) Relates to Payroll Assessment/Activity Analysis Survey.