The Regents of the University of California

COMMITTEE ON COMPLIANCE AND AUDIT
November 18, 2014

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

Members Present: Regents Engelhorn, Makarechian, Ruiz, Saifuddin, and Sherman; Advisory members Gilly and Oved; Staff Advisors Acker and Coyne

In attendance: Regent-designate Davis, Faculty Representative Hare, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, and Recording Secretary Johns

The meeting convened at 4:00 p.m. with Committee Vice Chair Ruiz presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of September 17, 2014 were approved.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES 2013-14**

[Background material was provided to Regents 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 presented the Annual Report on Internal Audit Activities for 2013-14. The audit program identified no material deficiencies in internal controls for this year. There was good cooperation from management, and matters of importance were reported to the Regents. Among the significant and recurrent internal control issues, information technology security and information privacy were the major areas of concern.

Mr. Hicks displayed a chart showing that the systemwide audit personnel headcount had declined during the recent economic recession, but had increased slightly in the last few years. Staff turnover over the past seven years showed a positive trend, with an anomaly during 2011-12, a period of restructuring in the internal audit program. There was a minor decrease in the average number of years of staff experience, mainly due to retirement of more experienced auditors and audit directors. Over the last year, the audit program has been hiring entry-level staff. Chief Compliance and Audit Officer Vacca explained how these hirings were part of the program’s succession planning.

Mr. Hicks observed that despite the change in the mix of audit staff, there was consistency in staff qualifications. The number of training hours per auditor has remained relatively consistent. The internal audit program has consistently met or exceeded its productivity goal of 85 percent. Productivity is measured as project time as a percentage of total available hours. In the program's effort distribution there had been a general trend toward a moderate increase in the amount of advisory services. This has been a strategic initiative, to carry out more proactive consulting work with management, rather than the traditional assurance-based audit activity. Ms. Vacca noted that advisory service activity is more complex and takes more time. Mr. Hicks indicated that this same trend was reflected in the number of projects per auditor. There had been a moderate decrease over the past seven years, from about 6.5 to 5.5 projects per auditor per year. The main cause of this change has been a 45 percent increase in the average number of hours per advisory project. This was a positive indication of more extensive advisory work. There was also a very positive trend in audit plan completion. Beginning in 2009-10 there was a significant increase in the completion of the internal audit plan, from 77 percent to about 95 percent.

Ms. Vacca explained that a chart of effort distribution by functional area showed where the program spends its time. Most audit time is spent in areas such as financial management, research, academic units and programs, health sciences operations, information management and technology, and auxiliary, business, and employee support services. These areas of focus are identified by a risk assessment at the beginning of each audit year.

Mr. Hicks reported that for the fourth year in a row, more Management Corrective Actions (MCAs) had been resolved than new MCAs added. The inventory of open MCAs had decreased by 58 percent over the last four years. The number of open MCAs over 300 days old had decreased by more than 50 percent over the past two years. Ms. Vacca recalled that MCAs are responses to audit findings.

Staff Advisor Acker referred to a chart that identified budget and resource constraints as a significant and recurrent internal control issue. She asked if these constraints were a lack of staff. Mr. Hicks explained that this category referred to the impact of budget constraints on the control environment. Management is more thinly stretched, which makes it more difficult to ensure appropriate segregation of duties and appropriate management review of key transactions.

In response to a remark by Committee Vice Chair Ruiz, Ms. Vacca discussed the most significant risks faced by the University in areas such as research and the health sciences and how the internal audit program focuses on these risks.

Regent Engelhorn asked about the cost of errors versus the cost of audit programs to reduce the occurrence of such errors. He stated that this report did not provide a sense of the relationship of risk to the cost of the program. It would valuable to the Regents to know the return on investment in the UC audit program, the standard for acceptable risk, and the cost of maintaining that standard. Ms. Vacca responded that benchmarks in dollar amounts had been used in the past but were no longer used. One reason is that there is too much disagreement about the materiality of various risks. There have been efforts to calculate what the cost of a catastrophic event, had it occurred, would have been. Savings in efficiencies have been measured. She stressed that certain risks are difficult to measure in dollar amounts, such as reputational risk. She recalled past incidents of public reaction to abuse of travel and entertainment funds.

Committee Vice Chair Ruiz noted that UC is required to perform certain audits that take time away from dealing with other, growing challenges.

Regent Engelhorn stressed that the Regents must make financial judgments and be able to demonstrate that the University is spending its money wisely. Although it might be difficult, there should be some way to measure the costs of processes to prevent problems compared to the cost of a problem. This is a factor in the Regents' decision-making. Ms. Vacca responded that the systemwide report reflects work done by audit teams on each campus. Information on budgets and return on investment for audit could be provided by campus.

Regent Makarechian referred to information in a chart showing 57 open MCAs over 300 days old in July 2014 and asked about the nature of these MCAs and how critical they were. Ms. Vacca responded that ten of the 57 could be considered significant priorities. The plans to address some of these MCAs, which are usually in information technology, might last two to three years.

Regent Makarechian asked how many of these ten MCAs were extremely urgent. Ms. Vacca responded that all ten matters are being addressed. Immediate remediation has been put in place to avoid any crises, but the long-term solution for these MCAs would take more time. All ten MCAs might be considered to be in the "extremely urgent" category and have reached a level where they receive the attention of chancellors. The internal audit program is in agreement with the mitigation plans that have been proposed by the campuses for these MCAs.

Regent Makarechian asked if some MCAs involved potential violation of federal or other regulations. Ms. Vacca responded that prioritization of MCAs includes consideration of relevant regulations. The University works quickly to address any issue of blatant noncompliance. The ten MCAs referred to earlier were not in this category, but in the area of controls.

Committee Vice Chair Ruiz praised the progress the University had made in addressing MCAs.

3. **ANNUAL REPORT ON ETHICS AND COMPLIANCE ACTIVITIES 2013-14**

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

Deputy Compliance Officer David Lane presented the Annual Report on Ethics and Compliance Activities for 2013-14. He noted that federal agencies are increasingly requiring effective compliance programs. The University's ethics and compliance program uses benchmarks issued by external and international organizations. In every case, the University has met or exceeded these programmatic benchmarks.

Mr. Lane briefly noted that there were a number of areas of focus for the ethics and compliance program in the current fiscal year. One was the area of privacy, a high-risk area. The Office of Ethics, Compliance and Audit Services (ECAS) led the coordination of systemwide Health Insurance Portability and Accountability Act (HIPAA) efforts. Another important accomplishment was the implementation of the UC Privacy and Information Security Steering Committee. UC is a national leader in higher education in this effort. Chief Compliance and Audit Officer Vacca observed that information security breaches are increasing nationwide. Combating database hacking is a significant challenge for UC, an organization with many employees, many students, and many avenues of input into its systems. The University has focused efforts on encryption and training. Ms. Vacca drew attention to the 300 percent return on investment from UC’s royalty audit program. The University has been able to identify weaknesses in contract language and implement appropriate controls, with the hope that underpayments will decrease in the future.

Regent Makarechian referred to information in the report according to which the royalty audit program had identified $3 million in underreported royalties and asked over how many years this had occurred. Ms. Vacca responded that this program had been ongoing for the past three years. She noted that UC’s royalty income is modest overall.

Regent Makarechian stated his understanding that UC’s annual royalty income is about $120 million. Ms. Vacca confirmed this and explained that the campuses have reported areas where they suspect underpayment.

Regent Sherman asked if the collection of royalties is centralized, or performed at the campus level. Ms. Vacca responded that when the University identifies an instance of underpayment, ECAS works with a key individual from the campus and an outside expert to negotiate with the outside entity.

Regent Makarechian stated that the Governor should receive a copy of a chart in the report displaying 32 different compliance matters affecting the University, and the relevant regulatory agencies. He emphasized that while the Governor speaks of the need for the University to be more efficient, this chart demonstrates that much UC staff time is wasted working on unnecessary regulatory requirements.

Committee Vice Chair Ruiz referred to Regent Engelhorn’s earlier remarks, and suggested that the University could quantify savings and costs in the audit program. At some future point the audit program would request more staff, and this information might provide justification for such an expense. He expressed concern about the great number of State regulatory requirements and the burden they place on the audit program.

Regent Saifuddin concurred that it would be helpful to have concrete numbers. While the State frequently advises UC to achieve more effective cost savings, the savings are small compared to the long-term disinvestment by the State. These numbers might solidify the University's argument for more State funding.

Committee Vice Chair Ruiz suggested that the University compose a list of "wasted audits," required by the State but not really necessary, to be communicated to the news media. Ms. Vacca recalled one example of two campuses that were required to perform hundreds of hours of work on documentation; the final audit finding amounted to $2,500, which had been due to an honest mistake, not a lack of controls. In complying with State and outside audits, the University often spends a great amount of time helping outsiders to understand the University's business practices. She offered to provide other examples.

4. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2014**

[Background material was provided to Regents 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 drew attention to the two reports provided, the audit of the University and the audit of the retirement plans. She observed that this had been the most complex year for the University's audit in her several years of experience at UC. The University implemented seven new accounting pronouncements this year, while in an ordinary year there might be one or two. UC has taken on a new external auditing firm. In addition, there was a very complex transaction this year, the acquisition of Children's Hospital Oakland. She anticipated that the audit report on the UC medical centers would be completed in the coming days; the report would be provided to the Committee in a few weeks. The external auditors' findings regarding the medical centers would also be provided between meetings.

KPMG representative Mark Thomas stated that the audits for the University's financial statements, for the UC system as a whole and for the retirement system, were complete. He briefly outlined the documents provided. KPMG's opinions on the Annual Financial Report and on the Annual Financial Report for the retirement system were unmodified. The Required Communications to the Regents' Committee on Compliance and Audit reflected auditing standards, which require that KPMG report certain matters to the Regents about the conduct of the audit. The Report to the Regents' Committee on Compliance and Audit or "management letter" includes any items considered significant deficiencies or material weaknesses in internal controls. The management letter this year identified three significant deficiencies.

Committee Vice Chair Ruiz asked about these three items. Mr. Thomas responded that the first item concerned the valuation of investments. Part of UC's investment portfolio contains unmarketable securities, such as alternative investments. UC is required to report the estimated fair value of these investments as of June 30. KPMG found that the portfolio was undervalued by about $430 million, about $90 million for the University as a whole, and the remainder for the retirement system. The second item in the management letter concerned control deficiencies in information technology systemwide.

Mr. Thomas noted that UC leaders across the system recognize this area as a significant risk issue. The third item concerned valuations at the UCSF campus and the UCSF Medical Center. The campus and Medical Center carry independent records of capital assets and accumulated depreciation. The assumptions used in their calculations were different, resulting in a difference of approximately $100 million in accumulated depreciation amounts. There were corrective actions in all three cases.

Regent Makarechian stated his view that the first item was not a matter of grave concern; this amount would be adjusted. The second item was of greater concern, with more extensive implications for the University, because data were lost and backup systems were not functioning. He asked how the University ensures that its data are backed up. The third item concerned a number that would be corrected as the accumulated depreciation at UC as a whole would be consolidated for the University's general balance sheet. Regarding the first item, Ms. Arrivas responded that this concerned private equities. The University estimates their value in July, soon after the end of the fiscal year. The external auditors see these valuations in September, with some values higher and some lower than the estimate; but the net difference is generally not large. In the current year, almost all the values were higher and added up to a large amount. She noted that based on discussions with the Office of the Chief Investment Officer, enhancements can be made to the process to better refine UC's valuation. In this case UC did not lose anything. Gains that UC would have recognized in future months were moved up to June. The University would be working on an improved process to estimate values in June every year.

Regent Makarechian observed that the only implication of importance in this case would be if the University were paying bonuses based on these calculations of the year's gains. He stated his understanding that these bonuses are based on a three-year period. He praised the University's efforts to correct its projections of gains and stressed his belief that UC had not lost anything. Ms. Arrivas confirmed that there had been no loss. From now on UC would use one consistent set of values and do a better job of estimating them. She then responded to the second item, concerning information technology and a server at the Office of the Chief Investment Officer. The University identified this issue in July and brought it to the external auditors' attention. The internal audit program performed a review. UC tried to recover and restore all data through email messages, manual files, or other sources. All significant files were recovered, with the exception of one. This was an isolated incident concerning one server that was not backed up. The University does not believe that this is a widespread problem. Regarding the third item, Ms. Arrivas noted that there are two sets of financial records at UCSF, one set for the campus and the Medical Center, and one set for the Medical Center. There was a $100 million difference between the two sets in the case of the Medical Center. UCSF had to make an adjustment to bring the two sets of books into alignment.

Regent Makarechian asked which number was used for the consolidated UCSF statements. Ms. Arrivas responded that the number from the Medical Center's records was used. This number was $102 million lower than the campus figure.

Regent Makarechian asked if the figure for UC's overall statements is correct. Ms. Arrivas responded in the affirmative. The University would develop a new process in the future to avoid this kind of variation.

Committee Vice Chair Ruiz underscored that the transition to new external auditors involved a great deal of work and expressed appreciation for the work of Ms. Arrivas and her team, and for the work of the external auditors. He asked about the report on the UC medical centers. Ms. Arrivas explained that the report on the medical centers would be provided between meetings. Committee Vice Chair Ruiz stated that it would be helpful to have a discussion of this report at the next meeting.

The meeting adjourned at 4:50 p.m.

Attest:

Secretary and Chief of Staff