

The Regents of the University of California

COMPLIANCE AND AUDIT COMMITTEE

November 14, 2018

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

Members Present: Regents Anguiano, Elliott, Estolano, Makarechian, Morimoto, Park, Pérez, Tauscher, and Zettel; Ex officio member Kieffer; Advisory member May; Chancellors Block, Gillman, and Leland; Staff Advisor Main

In attendance: Regent-designate Um, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Bustamante, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Vice President Humiston, and Recording Secretary Johns

The meeting convened at 11:00 a.m. with Committee Chair Elliott presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of September 26, 2018 were approved.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2017-18**

[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 Deputy Audit Officer Matthew Hicks presented highlights of the annual report on Internal Audit activities. Based on the work performed during the year, Internal Audit identified no material deficiencies in financial controls, and no instance in which management accepted an unreasonable level of risk. Internal Audit continued to have a good working relationship with management. Cooperation was smooth, and there were no instances of interference. All matters of importance are reported to the Regents.

Mr. Hicks presented some key performance measures. Internal Audit benchmarks itself relative to established goals and prior-year performance. All UC auditors log every hour of their work time. In all key measures, Internal Audit had exceeded its established goals and in most cases it had also exceeded the prior-year performance. The one exception was the rate of audit plan completion, which was slightly below the previous year's rate. Audit plan completion is measured as the percentage of projects completed that were included in the original audit plan. One reason for the decrease in the completion rate compared to the previous year was an increase in the number of supplemental projects that were added

during the year, as additional risks arose. Internal Audit issued about 50 more reports than in the prior year, and more than 100 additional reports compared to the original audit plan.

Each year, the University undertakes a limited number of systemwide audits. Each location conducts the audit work, using a consistent audit approach. Systemwide audits are typically added to the plan following implementation of a significant new policy or in case of a high-risk issue. Systemwide audits may also be requested by the Regents or senior leadership. The University conducted five systemwide audits this year. One was an audit of the Fair Wage/Fair Work Plan. The Plan had been initiated in 2015 and established a minimum wage for all UC employees working at least 20 hours per week, as well as employees of suppliers who are performing work on site at UC locations. This was the second audit of the Plan, and audit procedures again focused on ensuring that suppliers are adhering to Plan requirements. These requirements include an independent annual audit of suppliers who perform services worth at least \$100,000. This audit found that most UC locations need to improve processes to monitor suppliers' compliance with the annual audit requirement. Current rates of compliance were low: 24 percent at the campuses, and 11 percent at the medical centers. This indicated that the locations were not doing enough to hold suppliers accountable. Each location had committed to specific corrective actions to improve monitoring processes and increase compliance rates. In addition, the systemwide Procurement Services office was making modifications to streamline the annual audit certification process in order to facilitate compliance.

A systemwide audit of Outside Professional Activities (OPA) focused on policy requirements for members of the Senior Management Group. There was general adherence to OPA policy, but the audit identified some instances in which OPA requests were not approved in a timely manner, and some issues related to the accuracy of data in the system used to track OPA. The audit did not identify any significant errors in the reporting of OPA, or any instance in which the nature of an outside professional activity was in violation of policy requirements. Management had established corrective action plans to address the issues that were identified. Another systemwide audit, focused on executive compensation, identified minor issues at the local level, but not issues requiring systemwide action. The Cybersecurity Audit Team performed two systemwide audits, one focused on vulnerability assessment and penetration testing, and another on cybersecurity incident response.

Mr. Hicks then presented a chart showing the Internal Audit program's effort distribution or project time by area for the fiscal year. Nearly half of project time was allocated to three functional areas. Financial management accounted for 18 percent of audit effort, and included areas such as procurement, financial reporting, cash management, and payroll. Health science operations accounted for 16 percent, and information technology (IT) was the third-largest effort category, with the bulk of the time devoted to IT security and system implementations.

Mr. Hicks briefly commented on the internal control themes that emerged in fiscal year 2018. IT security remained a top risk, an area that is challenging for a highly decentralized organization like the University. Regulatory compliance was a challenge as well. UCPath and other large-scale system implementations were an area of focus. In the case of any

significant system implementation, Internal Audit seeks to be involved early in the process. Decentralization and staff turnover were issues of concern at the departmental level, where it is important that staff are aware of control and policy requirements. Internal Audit also identified issues of concern in laboratory safety and emergency management.

Mr. Hicks concluded his presentation with information on Management Corrective Actions (MCAs). For every issue identified in Internal Audit reports, a corresponding MCA is noted, with an established target date. MCAs are entered in a tracking system, and Internal Audit follows up with management until it has verified that MCAs have been completed. He presented a chart showing the number of open MCAs at the end of the year for the past five years, and a chart indicating the number of MCAs that have been open for 300 days or more from June 2015 to June 2018. The current number of open MCAs was within the range typical of the past five years, although there had been a recent increase in the number of MCAs open for longer than 300 days. Internal Audit had implemented measures that it hoped would accelerate resolution of some longstanding MCAs, including formal notifications to chancellors when an MCA remains open for 300 days.

Regent Makarechian asked about the reasons for staff turnover. Mr. Hicks explained that this audit issue referred to staff at UC in general, not specifically within Internal Audit. There had been a growing number of retirements over the past three years, as more UC employees were reaching retirement age. This was natural attrition, common in any organization, and a risk that any organization must mitigate through succession planning, and documentation of procedures and controls to ensure knowledge transfer.

Regent Makarechian observed that there were about 30 high-risk outstanding MCAs and asked for examples of high-risk MCAs. Mr. Hicks responded that high-risk MCAs are found in areas such as IT security vulnerabilities and cash management vulnerabilities, where a significant problem might result if a control deficiency is not addressed immediately.

Regent Makarechian asked about the materiality threshold for financial risk. Mr. Hicks responded that there is not a strict dollar threshold for determining, for example, which matters would be brought to the Regents' attention. This determination is based on a combination of factors. With respect to financial reporting, a material weakness, as defined by the external auditors, would occur if a control deficiency could result in a material financial misstatement. This and other considerations are taken into account.

Regent Makarechian asked about Internal Audit's work in reviewing UCPATH. Mr. Hicks responded that Internal Audit had carried out a number of projects related to UCPATH. As UC locations implement UCPATH, Internal Audit makes pre-implementation assessments to review test plans, procedures in place for training, and data conversion controls. Internal Audit had also reviewed future state process designs. Typically, a great deal of organizational change occurs with the implementation of a large IT system. Processes are centralized and reconfigured. Internal Audit would evaluate controls in place to address the risk entailed by these changes, and would review the design of the system itself. Internal Audit had reviewed the segregation of duties in UCPATH.

Regent Makarechian asked if Internal Audit staff were on site, monitoring the implementation of UCPATH and complaints at the different locations. Mr. Hicks responded that the primary responsibility for monitoring complaints rested with management. Internal Audit reviews the complaint resolution process and risk management.

Regent Zettel noted that Internal Audit had engaged Deloitte and asked how many hours Deloitte was contributing. Mr. Hicks responded that earlier in the year, Internal Audit completed a Request for Proposals to identify a dedicated provider for internal audit services for the Office of the President and the other UC locations. The University may turn to an outside provider when there is staff turnover, to augment UC staff. More frequently, an outside provider is used to deliver required subject matter expertise. He could provide the number of hours Deloitte had worked to date.

Regent Zettel asked if the student intern program was saving hours for Internal Audit. Mr. Hicks responded that this program has been successful, and a few interns had gone on to become full-time UC auditors. It would be difficult to estimate the number of hours saved, since interns are involved for short periods of time.

Regent Zettel asked about concerns expressed by speakers during the public comment period about problems with UCPATH payments for students and staff. Mr. Hicks responded that this topic would be addressed later that day in the meeting of the Finance and Capital Strategies Committee. There was a general expectation that UCPATH would not operate flawlessly upon implementation, that there would be need for manual work-arounds to achieve implementation deadlines, and that the problems being reported would ultimately be resolved through customization.

Regent Park expressed concern about the low degree of compliance with Fair Wage/Fair Work Plan requirements. She asked if this was typical when new requirements and initiatives are implemented, about the extent of noncompliance, and about corrective actions. Mr. Hicks responded that the degree of noncompliance in this case was greater than for other new policies, but pointed out the complexity for campuses of implementing the Plan requirements. It was challenging for management to identify all contracts under which UC receives \$100,000 or more in services because there are different contract anniversary dates. With regard to the extent of noncompliance, he observed that the first-year audit of the Plan had found that many locations were not even including the Plan requirements in contracts and had no mechanism to identify contracts subject to the Plan. This year, Internal Audit found that most locations had established processes to identify and track contracts subject to the Plan. Campuses were sending out letters reminding suppliers about the audit requirement, but Internal Audit had not observed follow-up activity if the supplier did not respond. With regard to the question of how many suppliers were not paying a fair wage as opposed to just not completing the audit, based on 67 certifications that had been received, only in four instances was the supplier not paying a fair wage. In those cases, the University ensured that an action plan was in place to correct these situations retroactively.

Chancellor Block asked how laboratory safety is audited. Mr. Hicks responded that Internal Audit reviews the level of compliance with required training, as well as controls over the inventory of chemicals. Internal Audit examines past Environment, Health and Safety reviews and how quickly corrective actions were implemented. These were examples of objective measures of laboratory safety.

Regent Morimoto noted that the number of advisory services hours had increased substantially. He asked if this was due to a project or two, or if it represented a changing of scope for Internal Audit. Mr. Hicks responded that this was due to the latter; for the past several years, the Internal Audit program had emphasized engagement with management to identify issues early on, in a proactive manner, rather than auditing after the fact. After an IT system has been implemented, it may be too late to correct certain errors. Chief Compliance and Audit Officer Bustamante anticipated that the number of advisory hours would increase in the future, as Internal Audit strengthens its relationships across campuses and disciplines.

Regent-designate Um asked about the tangible benefit, such as cost reduction, derived from the work of the Internal Audit program. Mr. Bustamante responded that some improvements resulting from audit work are difficult to quantify, such as costs that are avoided because a problem is identified by auditors early on. Some tangible benefits are gained in the insurance realm, and some control-related issues in health care or cybersecurity can be quantified to some extent, based on a calculation of what harm could be done if appropriate systems were not in place, or if systems were not tested regularly. He noted that Internal Audit's partnerships with the Office of the General Counsel and the Office of Risk Services would allow for benchmarking and tracking of year-to-year improvements. Mr. Hicks added that MCAs provide an important measure of the benefit derived from audit work, a measure of how quickly issues are being resolved, if issues are receiving the appropriate attention, and if funding requests associated with MCAs are being appropriately prioritized. The other positive impacts of audit work are more difficult to measure.

Regent-designate Um stressed that it would be helpful, whenever possible, to show the tangible benefit. Mr. Bustamante responded that Internal Audit was working to develop benchmarking that would indicate when training has led to improvements and audits are having positive effects. The infrastructure for this benchmarking was not yet in place. General Counsel Robinson stated that tangible benefit could be demonstrated in the realm of cybersecurity. He recalled a significant data security breach at the UCLA Medical Center a few years earlier. As the result of an extensive cyber governance program and other audit activities undertaken since then, the insurance terms and premiums for the University's cyber risk had improved dramatically.

Regent Estolano referred to the systemwide audit of OPA. The audit report indicated that additional communication would be necessary, including guidelines on how to record royalty income. She asked if this was a significant issue, if royalty income was not being recorded at all, or if this matter had arisen because this was a new requirement. Mr. Hicks

responded that the OPA policy did not specifically address this topic. The Office of Human Resources was working on enhancing guidance on reporting royalty income.

3. **REPORT ON INDEPENDENT ASSESSMENT OF AUDIT IMPLEMENTATION STATUS**

[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.]

Kurt Sjoberg of Sjoberg Evashenk Consulting introduced his firm's sixth quarterly report, covering the period July 1 to September 30. The focus of this period was the beginning of the Office of the President's (UCOP) work to address the 2019 or second-year recommendations from the State Auditor. He noted that UCOP had reduced the number of its workstreams from ten to six, which reflected the completion of work on first-year recommendations. There were 11 second-year recommendations, and they were to be implemented by April 2019. UCOP believed, and Sjoberg Evashenk concurred, that five of these 11 had already been implemented. Several areas of work were in progress, and Sjoberg Evashenk would closely monitor this work. In response to a question by Committee Chair Elliott, Mr. Sjoberg stated that there were challenges, but not urgent concerns to bring to the Committee's attention.

Marianne Evashenk of Sjoberg Evashenk Consulting opined that implementation of recommendations regarding workforce development would be challenging. The workstream addressing this task had a number of initiatives and studies under way that should be reaching completion in the next month or so. There were continuing issues related to the budget, and the narrowing of salary ranges was another challenging area. UCOP had set aggressive deadlines for itself and appeared to be keeping up with them.

4. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2018**

[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.]

PricewaterhouseCoopers (PwC) representative Will Cobb reported that PwC's audit was completed on time and in accordance with the University's expectations, which were outlined during the planning phase of the audit. The audit was completed with an unqualified, "clean" audit opinion, a result that organizations strive to achieve. PwC identified no audit adjustments and no material weaknesses in internal controls. PwC had observed significant enhancement in information technology controls; much work had been done at a number of UC locations to achieve this result. PwC received complete cooperation from management, and there were no significant disagreements in the performance of this year's audit.

Regent Makarechian remarked that the audit referred to a new potential pension liability of about \$9.8 billion and a liability of approximately \$19 billion for retiree health benefits.

He asked why the amount cited for retiree health benefits was a liability, since this is not a vested benefit. He referred to control deficiencies identified in PwC's report and asked how these were being tracked. With regard to retiree health benefits, Associate Vice President Peggy Arrivas explained that accounting standards had changed. The University had implemented new accounting standards for retiree health liability the previous year. If the University has a practice of continuing to pay this liability, it is required to report the entire liability in its financial statements.

Regent Makarechian stated his view that by reporting in this manner, the University was creating a liability that was not in fact a liability, since these benefits are funded on a pay-as-you-go basis. Ms. Arrivas confirmed that the University was funding these benefits on a pay-as-you-go basis. Accounting standards require that if an entity has a practice of paying these benefits, even if they are not vested benefits, it must estimate the liability and record it in the financial statements. These are not vested benefits, and the University has the ability to rescind them. If the University made adjustments to these benefits, it would make corresponding adjustments to the liability for that year. This reporting did not preclude the University from making changes to these benefits in the future. In response to a question by Chair Kieffer, Ms. Arrivas stated that the retiree health benefit plan was explained in the financial statements. The explanation covers eligibility requirements and states that this is not a vested benefit; she noted that this statement could be made stronger. Chair Kieffer and Committee Chair Elliott requested that this change be made.

Regent Makarechian again expressed his concern that the University was creating a long-term liability for itself simply by reporting these figures. General Counsel Robinson stated his view that this was not the case. Accounting standards are different from a legal standard. Committee Chair Elliott urged the University to be as careful and clear as possible in making these statements.

Regent Pérez remarked that the distinction between an obligation to report the liability due to UC's practice and an obligation to carry this practice forward could be made clearer. He stated his understanding that under accounting standards, the University must record this liability as it has done. Nothing precludes the University from including more detailed explanations in its financial statements to the effect that UC does not have an ongoing obligation to provide these benefits. Another issue was a policy question that should be considered by the full Board: the relative merits of the pay-as-you-go approach versus pre-payment. Pre-payment might significantly reduce the cost of providing these benefits. Committee Chair Elliott agreed that this topic should be discussed at a future meeting with all the Regents.

Regent Zettel referred to information included in PwC's report about the impact of prospective reporting requirements in Governmental Accounting Standards Board (GASB) Statement No. 83. She asked what the Regents should be concerned about in connection with this Statement in an uncertain financial environment. Mr. Cobb explained that GASB 83 pertained to asset retirement obligations. It would be important for the University to understand the expected and actual impact of this new accounting standard. He anticipated that this requirement would not be uniquely affected by interest rates or other financial

uncertainties. For the reader of the financial statements, the “Management’s Discussion and Analysis” sections outline the University’s financial environment, including possible future uncertainties concerning financial instruments and fair value measurements of significant investment holdings. There are opportunities for disclosure of various risks and uncertainties with respect to the University’s investments.

Regent Zettel referred to the “trending topics” identified in PwC’s report, and asked if there were one or two that represented the greatest risk to the University, and on which UC should especially focus its attention. Mr. Cobb responded that a certain number of significant accounting standards would be implemented in the coming years. An upcoming GASB leasing standard would require all leases, even operating leases, to be recorded on the balance sheet, and this would require a tremendous amount of data gathering. GASB Statement No. 84, a fiduciary funds standard, would affect UC management’s annual work in preparing the financial statements. This standard would require additional audit opinions to be issued for fiduciary funds. These new standards would not be effective in fiscal year 2019, but would have a significant impact in the years following.

Faculty Representative May referred to the question of the pay-as-you-go approach versus pre-payment for retiree health benefits. The Academic Senate’s Health Care Task Force had been studying this topic for a number of years, and the Academic Senate would be glad to participate in this discussion. The Health Care Task Force had relevant information, including costing estimates and contribution estimates for the University and UC employees.

Regent Anguiano asked about GASB Statement No. 89, “Accounting for interest cost incurred before the end of a construction period.” UC had an effective commercial paper program. She asked if GASB 89 would affect the University’s ability to use this program for funding capital projects, or what effect it might have. Ms. Arrivas responded that GASB 89 should not have an impact on interim financing using commercial paper. The University would continue to pay the interest cost as it had in the past. This accounting standard would affect the amount capitalized as part of the asset versus the amount recorded as an expense. The University capitalizes roughly \$60 million to \$70 million annually within its capital assets; this would be reported as an expense. The University would implement this standard effective July 1, 2020. GASB 89 would not affect cash flow, but only the presentation on the financial statements.

Chair Kieffer praised the work of the Ethics, Compliance and Audit Services staff and stressed the importance of compliance.

The meeting adjourned at 11:55 a.m.

Attest:

Secretary and Chief of Staff