The Regents of the University of California

**COMPLIANCE AND AUDIT COMMITTEE**
March 14, 2018

The Compliance and Audit Committee met on the above date at the Luskin Conference Center, Los Angeles campus.

| | |
|---|---|
| Members Present: | Regents Anguiano, Elliott, Makarechian, Newsom, Pérez, Tauscher, and Zettel; Ex officio member Kieffer; Advisory members Anderson and White; Chancellors Blumenthal, Khosla, and Yang; Staff Advisor Valdry |
| In attendance: | Regents Monge and Napolitano, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Bustamante, Provost Brown, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Vice President Holmes-Sullivan, and Recording Secretary Johns |

The meeting convened at 10:05 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 January 24, 2018 were approved.

2. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2018**

The President of the University recommended that the Compliance and Audit Committee recommend to the Regents that the PricewaterhouseCoopers external audit plan and fees for the University for the year ending June 30, 2018 be approved as shown in Attachment 1.

[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 Peggy Arrivas recalled that this was the third year of a three-year contract with PricewaterhouseCoopers approved in 2016. The scope of the proposed audit was consistent with the previous year's service plan.

PwC representative Will Cobb outlined elements of PwC's audit plan. The PwC service team included a number of specialists, reflecting the complexity of this audit. PwC had identified three areas of significant risk to the University, to which it would devote special attention: management override of controls, fraud risk in revenue, and the valuation of certain alternative investments. The proposed audit timeline was consistent with past PwC audits. Referring to the section of the plan titled "Required Communications with the

Committee on Compliance and Audit," Mr. Cobb noted that the matters listed in this section were standard, with nothing out of the ordinary.

Committee Chair Zettel expressed appreciation for the fact that there had been only a modest increase in fees. She referred to the information on fraud risks in the "Required Communications" and how "immaterial instances of fraud" would be reported. She requested a definition of "immaterial fraud." Mr. Cobb responded that often, in the course of an audit, PwC becomes aware of instances of petty theft, such as a theft of petty cash by staff. Typically these matters are addressed by the University's internal audit program. PwC wishes to ensure that internal audit is aware of and responds to these instances. PwC would be concerned if the individual involved were part of the control environment.

Regent Tauscher asked about the materiality threshold, a dollar amount that distinguishes petty theft from material loss. Mr. Cobb responded that in the case of a theft of several hundred dollars, PwC would refer the matter to internal audit; theft of tens of thousands of dollars would be brought to the Committee's attention.

Regent Tauscher requested a definition of an individual who is part of the control environment. Mr. Cobb responded that this refers to an individual in an oversight position, with the ability to influence others, a member of management. He confirmed that PwC's approach in this area was an industry best practice, to ensure that no inappropriate activities were taking place.

Committee Chair Zettel stated that the Chair and Vice Chair of the Committee are notified when instances of petty theft come to light, and that follow-up measures are taken to ensure accountability.

Regent Makarechian observed that materiality is defined as a percentage, and requested clarification of what amount this percentage would be based on. He stressed that even a small percentage, such as 0.001 percent, if based on the consolidated financial statements of the University, would be an enormous number. Mr. Cobb responded that PwC issues many audit opinions for the University. For each of these audits, there is a separate determination of quantitative materiality. In the audit of an individual medical center, materiality would be based on the operating revenues of that medical center. For the University overall, materiality would be a percentage of total assets, one to two percent. He clarified that materiality is not the same as PwC's "audit adjustment posting scope." PwC would bring to the Regents audit adjustments at a much lower level than the materiality threshold, because there is a risk that audit adjustments can aggregate to a material level.

In response to another question by Regent Makarechian, Mr. Cobb clarified that although one report is issued for the UC medical centers, there are individual audit opinions for each medical center, and each medical center has its own materiality threshold.

Regent Makarechian observed that PwC requires cooperation from the Board of Regents. He asked how PwC assessed the Committee in fulfilling its responsibilities. Mr. Cobb confirmed that PwC evaluates the Committee's effectiveness. A significant element of this effectiveness would be the Committee's discharging its governance responsibilities, as it was doing at this meeting.

Regent Makarechian asked if PwC would update the Committee on potential changes by the Governmental Accounting Standards Board (GASB) and in generally accepted accounting principles. Mr. Cobb responded that the best practice would be for UC management, when PwC issues its final report, to report to the Regents on the impact of new accounting pronouncements. PwC would then discuss its audit procedures related to management's adoption of new accounting guidance, as well as any looming changes on the horizon. One such impending change would affect leases; in the realm of for-profit organizations, the Financial Accounting Standards Board had issued new guidance for lease accounting. GASB had issued this guidance as well, that all leases be recorded on balance sheets. Regent Makarechian emphasized the magnitude of this change, and its impact on liabilities and covenants.

Committee Chair Zettel noted that the background materials included some discussion of GASB Statements Nos. 83, 84, and 87, and the future impact of these Statements when they became effective for the University. Statement No. 83, Certain Asset Retirement Obligations, would have a significant fiscal impact on UC. Statement No. 87, Leases, might affect the University's grants and lead to loss of income. The work required for this reporting would affect UC staff. She asked if the University was considering hiring additional staff to address these new regulatory requirements. Ms. Arrivas responded that her staff oversees work related to implementation of new accounting standards. In the current year, UC was implementing GASB Statement No. 81, Irrevocable Split-Interest Agreements, and for a short time, UC used a contracted resource to help gather data. In general, there is a higher cost for implementation of new standards in the first year, but UC staff are able to absorb that cost in the following years; the University finds ways to automate the process without significant changes in staff. Statement No. 87, Leases, would not be applicable to the University until 2021. Ms. Arrivas noted that she had worked with GASB representatives on this matter and asked for a long implementation period for the University. The impact of this Statement would be substantial, but the University was already beginning work to manage the cost of implementing this new standard. An early start was prudent for an institution of UC's size and complexity.

Regent Makarechian referred to information provided in the background materials about audit committees that have incorporated risk and compliance into their names and charters. He asked if the Committee's name should be changed. Ms. Arrivas responded that an essential point was that it be clear that the Compliance and Audit Committee oversees audit activity and that external auditors report to this Committee. Committee Chair Zettel observed that the Committee had become more involved with risk issues in recent years, in particular information technology and cyber security. The Committee charter might be updated at some future point. PwC representative Michael MacBryde added that among his clients, audit committees were taking on more functions, in compliance, risk, cyber security, and enterprise risk assessments. Regulatory oversight had become more significant, and it had become common to rename committees to include audit, compliance, and risk.

Regent-designate Anderson asked if PwC felt comfortable and independent in raising issues as PwC became aware of them, even very serious issues, with the President and the Chair of the Board. Mr. Cobb responded in the affirmative, noting that there was a spirit of transparency in the organization and its leadership. PwC wishes to feel that it has the ability to communicate directly with those in charge of governance and with executive leadership.

Committee Chair Zettel asked that Appendix D of the PwC Audit and Communications Plan ("Perspectives in Higher Education 2017" and "Top health industry issues of 2018") be shared with the members of the Health Services Committee.

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

3. **REAPPOINTMENT OF EXPERT ADVISOR TO THE COMPLIANCE AND AUDIT COMMITTEE**

The Chair of the Compliance and Audit Committee recommended to the Committee that Eric Juline be reappointed as Expert Financial Advisor to the Committee for an additional one-year term, effective immediately.

[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.]

Committee Chair Zettel stated that the Committee was pleased that Eric Juline would continue to serve as Expert Financial Advisor to the Committee. Mr. Juline was a retired partner with PricewaterhouseCoopers and a graduate of UCLA.

Upon motion duly made and seconded, the Committee approved the Committee Chair's recommendation.

4. **SUMMARY RESULTS OF THE UNIVERSITY'S 2017 AUDIT OF COMPLIANCE FOR FEDERAL AWARDS (UNIFORM GUIDANCE)**

[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 Peggy Arrivas began the presentation by confirming that the 2017 Uniform Guidance report was complete. The University had received $5.5 billion in federal awards in 2017, and this report was required in connection with these awards. For this year, PricewaterhouseCoopers (PwC) had eight findings in the areas of student financial aid, research and development, and information technology. The one finding regarding information technology systems had been included in the last external audit report and was repeated here. The campuses were aware of these findings and were working to address them. Some of the findings had been repeated from the previous year because the University was still in the process of implementing corrections during the current fiscal year, but Ms. Arrivas expressed optimism that the University could remedy all the findings within this fiscal year.

PwC representative Will Cobb cited some summary results from this comprehensive audit of federal grants and contracts. He noted that a number of the financial statement audit results had been carried forward into the Uniform Guidance report, and those results had been communicated to the Regents at a previous meeting. With respect to federal awards, no material weaknesses were identified. This audit report had focused on four major programs, the research and development cluster, the student financial assistance cluster, the Title IV foster care cluster, and the Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP) cluster. Uniform Guidance regulations have a formulaic approach to identification of major programs. The University qualified as a low-risk auditee in the 2017 Uniform Guidance audit.

Regent Makarechian referred to one of the findings concerning equipment, in which a campus had overstated a cost by $418. He asked about the materiality threshold in this case. Mr. Cobb responded that the Uniform Guidance audit identifies materiality at the individual major program level, and the materiality threshold is three percent of total expenditures for that program. Any finding must be reported to the federal government, even a small finding of only hundreds of dollars. Ms. Arrivas added that the University is held to a very high standard in the Uniform Guidance report by the federal government, and that there were not many questioned costs in this report.

Committee Chair Zettel observed that there had been fewer findings in this report every year, and that the findings were not significant; but responding to this audit was an important effort, given the large amount of federal support the University receives. With regard to risks facing the University, she wished the Committee in the future to take into consideration risks regarding faculty and staff retention and morale, and reputational risk, in light of the economic pressures on UC, and the additional workload for faculty and staff brought on by increasing student enrollment. Mr. Cobb responded that this was a concern for institutions of higher education across the U.S. UC should be examining how faculty and staff retention would affect its strategic, long-term focus.

5. **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 recalled that the State Auditor had made 33 recommendations to the Office of the President (UCOP) to be implemented over three years. In addition, the State Auditor had made recommendations to the Regents, including one for a financial audit of UCOP. The financial audit of UCOP was complete, but the State Auditor believed that it had not fulfilled the recommendation. In Sjoberg Evashenk's view, the Regents must be involved in the solution of this matter, as this may entail additional costs. The State Auditor had agreed to an approach to address concerns, and would accept the outcome of the process.

Mr. Sjoberg further recalled that the deadline for implementing ten of the 33 recommendations was April 2018. The relevant UCOP workgroups had been diligent in preparing to meet this deadline. Some actions were complete or nearly complete in January, with regard to employee benefits, workforce planning, and the formation of the Executive Budget Committee. As of January, other, more challenging issues remained to be resolved, such as salaries, the budgeting process, budget presentations, fund restrictions, and reserves. Sjoberg Evashenk would review UCOP's one-year response in draft form, before it would be issued to the State Auditor. Beyond achievement of these ten recommendations, implementation of the remaining 23 was spread out over the following two years. In many areas, the remaining 23 recommendations were related to the first ten recommendations. Mr. Sjoberg underscored that UCOP's response to the State Auditor one year after the recommendations had been issued was an important point; earlier responses, at 60 days and six months, were preliminary approaches. In his own experience as former State Auditor, he would expect, at the one-year mark following audit recommendations to an agency, to see either implementation or a convincing good faith effort toward achieving implementation. He anticipated that by early April, Sjoberg Evashenk would be able to provide an in-depth look at UCOP's one-year position in its responses to the State Auditor, and as he hoped, provide the Regents some confidence that the State Auditor would accept these responses.

Regent Makarechian asked about the follow-up work with the State Auditor regarding the financial audit of UCOP. Mr. Sjoberg responded that certain Regents and Associate Vice President Peggy Arrivas would work directly with the State Auditor. Ms. Arrivas explained that the State Auditor had concerns in three areas of the UCOP financial audit. One area was fund restrictions and carry-forward balances. A discussion item later that day in the Finance and Capital Strategies Committee, *University of California Office of the President Fund Restrictions*, would address this issue, and the State Auditor indicated that this discussion would meet this request for additional information on fund restrictions. The second area was process and controls in the UCOP budget office. Because the UCOP budget format and procedures were being revised for this year's budget, the State Auditor was willing to consider having UC's internal audit program, possibly with the assistance of an outside consultant, examine and assess procedures and controls in the first quarter of 2018-19, after changes were implemented. The third area was disaggregation of revenues and expenses for UCOP major programs. Ms. Arrivas' office had agreed to provide a schedule of these data to the State Auditor and to the Regents by June 30. UCOP would also receive feedback from the Regents as to whether these data were useful. UCOP essentially developed a plan with the State Auditor to address the three concerns, and the process for addressing each concern would be completed over the next six months. This follow-up work would not involve PricewaterhouseCoopers. Committee Chair Zettel noted that the University was grateful that the State Auditor was willing to accept UC's solutions for providing transparency in these areas.

Chancellor Blumenthal remarked that one element of the Sjoberg Evanshenk report had given rise to considerable discussion among the chancellors, the inclusion of State and California State University (CSU) employees' salaries in salary comparisons, as proposed by the State Auditor. Many chancellors have expressed the concern that UC is a more complex organization than CSU or the State government. UC has a research function, grants Ph.D. degrees, oversees medical centers, and has a higher graduation rate for undergraduates than does CSU. The qualities UC would seek in its senior administrators were not comparable to those CSU or the State government might seek. Mr. Sjoberg responded that his firm had carried out a substantial analysis of this issue. The firm had a subject matter expert in the field of compensation and classification, who examined the University's past approach and confirmed that under normal circumstances, one would not consider CSU or the State government as direct competitors. Nevertheless, Sjoberg Evashenk understood that there were directives from the Legislature and the State Auditor. The University would consider the appropriate weighting of salaries for certain positions. For some UC positions, there might be comparable positions within CSU, but for most, there would likely not be an appropriate match. Committee Chair Zettel added that there would be further discussion of this issue by the Governance and Compensation Committee.

In response to a question by Chair Kieffer, Mr. Sjoberg stated that his firm's view that it would be appropriate to give State positions no more weighting than they are given in some major surveys. For instance, if a survey included 40 positions, among them a CSU position, the weighting for any one of the positions should be only one-fortieth, but the approach being proposed would assign much greater weight to CSU positions.

Chair Kieffer asked about other universities and their use of comparator data from states. Mr. Sjoberg responded that UCOP workgroups engaged on this matter had examined data from Association of American Universities (AAU) institutions. Positions in some State departments might be comparable to UC positions, while other entities would rarely be compared to UC, with its research mission.

Faculty Representative White stressed the importance of making appropriate comparisons. State law clearly differentiates the role, duties, and responsibilities of the University from other education segments and State agencies. Mr. Sjoberg added that UC performs many back office functions for its campuses. A comparison with CSU might not take into account the fact that CSU uses the California Public Employees' Retirement System as its retirement system. This was also the case for debt management and investments. The California Community Colleges, CSU, and UC had unique and complementary roles in providing education in California, as embodied in the California Master Plan for Higher Education. The University needed to be clearly and accurately represented and described in the context of comparisons.

Chancellor Yang recalled that six UC campuses were AAU members. The Santa Barbara campus did not have a medical school or a professional school. Federal research grant funding at UCSB, divided by the number of faculty, was equivalent to $250,000 per faculty member per year. This distinguishes a research university in a monetary sense. All UCSB faculty are required to publish articles and books in order to be considered for merit increases. Faculty publications are used in classroom teaching; the knowledge developed by UCSB faculty contributes to education, and this was another distinguishing feature of the research university. These unique features of a research university need to be taken into account.

Chair Kieffer recalled that the University had accepted all the recommendations of the State Auditor, including a recommendation to review salaries and compensation. The University might disagree with the State Auditor about how to apply the results of the review. Currently there was effective communication between UCOP, the State Auditor, and the Regents.

Regent Elliott observed that the University might also have a disagreement with the Legislature on this matter.

The meeting adjourned at 11:05 a.m.

Attest:

Secretary and Chief of Staff

# PwC Services and Related Deliverables to the University

In conjunction with our service in providing audit services to the University, we also provide certain other assurance services to the University. Refer to the table below for a listing of services and related deliverables we expect to provide. Prior to commencing any non-audit related 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. For audit objectives and responsibilities and communication plan, please refer to **Appendix B.**

| | |
|---|---|
| Audit Reports | ▪ Report on the financial statements of the University of California<br>▪ Report on the financial statements of each of the five Medical Centers<br>▪ Report on the University of California Retirement System<br>▪ Report on the University of California Cash Contributions to the Retirement System<br>▪ Reports on federal awards in accordance with OMB *Uniform Guidance* |
| Internal Control Observations | ▪ Report to the Committee on control and process deficiencies and observations, including material weaknesses and significant deficiencies (Regents Letter)<br>▪ Reports to the campus Chancellors on control and process deficiencies and observations (Chancellor Letters) |
| Agreed-Upon Procedures | ▪ Agreed-upon Procedures related to the University's Mortgage Origination Program and Supplemental Home Loan Program<br>▪ Agreed-upon Procedures on Intercollegiate Athletic Departments (NCAA requirements) for six campuses |
| Other Services | ▪ Review of consolidated Form 990-T of the Regents of the University of California and University of California Retirement Plan<br>▪ Reviews in connection with bond offerings<br>▪ Accounting consultations and other assistance associated with emerging accounting and reporting issues and complex transactions |
| Committee Reporting | ▪ Audit and communications plan<br>▪ Results of audits and required communications |

We note that the campus foundations and Fiat Lux Risk and Insurance Company ("Fiat Lux") have separate audits of their financial statements and the auditor's reporting on those organizations are directed to their respective audit committees. Accordingly, this Audit and Communications Plan is not focused on the specifics of the campus foundations and Fiat Lux.

# 2018 Proposed Fees

The University is an important client of PwC, and our fees reflect our commitment to our long-term relationship with the University. Our deep understanding of higher education organizations and more specifically, of the University, enable us to perform the audit efficiently and effectively. These factors contribute to a competitive, cost effective audit. Our 2018 proposed fees are listed below and are inclusive of all out-of-pocket expenses which is consistent with our fee commitment agreed in 2016 as included in the professional services agreement signed on April 21, 2016 (inclusive of subsequent amendments).

| Deliverable | | June 30, 2018 Proposed Fees |
|---|---|---|
| University of California Financial Statement Audit | $ | 1,550,532 |
| Federal Grants and Contracts Audit in Accordance with OMB Uniform Guidance | | 525,427 |
| NCAA Agreed-Upon Procedures (6 reports) | | 212,439 |
| Review of Consolidated Form 990T | | 11,642 |
| Medical Center Audits (5 separate opinions) | | 1,787,283 |
| Retirement Plan Cash Contributions | | 6,284 |
| Retirement System Audits (2 defined benefit pension plans and 4 defined contribution plans) | | 272,947 |
| Mortgage Origination Program Agreed-Upon Procedures | | 41,387 |
| **Total** | **$** | **4,407,941** |