

Minutes\*

**Senate Committee on Finance and Planning**  
**Tuesday, February 5, 2013**  
**2:30 – 4:00**  
**238A Morrill Hall**

Present: Will Durfee (chair), Dan Feeney, Catherine Fitch, Susan Hupp, Russell Luepker, Jill Merriam, Fred Morrison, Paul Olin, Ann Sather, Arturo Schultz, Michael Volna, Aks Zaheer

Absent: Gary Cohen, Lincoln Kallsen, Kara Kersteter, Talha Khan, Ruth Lane, Richard Pfitzenreuter, Jahon Rafian, Gwen Rudney, Terry Roe, Michael Rollefson, S. Charles Schulz, Kyle Smyth, Thomas Stinson, Pamela Wheelock

Guests: Associate Vice President Gail Klatt (Department of Audits)

[In these minutes: (1) annual financial report; (2) emerging issues in audits and risk; (3) bank cards]

**1. Annual Financial Report**

Professor Durfee convened the meeting at 2:30 and turned to Mr. Volna for a review of the University's Annual Financial Report.

Mr. Volna distributed copies of the slides he used to present the report to the Board of Regents and told the Committee that the report is primarily for external audiences. It is not intended to be used for budgeting or other decisions; the data rest on generally-accepted accounting standards. He began by touching on the highlights of the 2012 report.

-- The University's finances continue to be strong and prudently managed. The higher-education sector generally has been given a negative outlook by Moody's, the rating agency, but the University's bonds have been given a stable rating; it is in a rarified area where it has great financial ratings. Mr. Volna repeated a point Mr. Pfitzenreuter had made at earlier meetings: There is little reason to seek to change the University's Aa1 rating to AAA.

This is an assertion the University is making about its own finances, Professor Durfee observed. Is there a basis for it? Mr. Volna said it is subjective but is based on financial statements audited by an external firm that audits to high standards, an audit that identifies a number of strengths, including the earnings streams. The University has solid finances compared to a number of its peers and also has better state support.

-- Net assets increased by \$124.7 million.

-- Total revenues decreased while operating expenses were up slightly.

-- FY 2012 cash flow of (\$63.5) million was \$192 million less than FY 2011.

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\* These minutes reflect discussion and debate at a meeting of a committee of the University of Minnesota Senate; none of the comments, conclusions, or actions reported in these minutes represents the views of, nor are they binding on, the Senate, the Administration, or the Board of Regents.

-- Deloitte issued an unqualified opinion on the audited financial statements.

Mr. Volna turned to the balance sheet and began with an overview of assets 2012 versus 2011, of which there are two significant categories, investments/cash and capital assets; the remainder of the categories (receivables, other assets) is stable and relatively insignificant. The capital assets increase when the University builds something and go down when it depreciates facilities. The Annual Financial Report investment balances are up about \$200 million from the prior year because of better market returns and because the Office of Investments and Banking (OIB) is using a different strategy in investing cash.

-- Total University assets increased by \$228 million (4.5%).

-- Cash & equivalents decrease of \$62 million, which represents an investment strategy of holding less cash in cash accounts and putting it into higher-yielding securities.

-- Investments up \$211 million due to higher TIP investments, and CEF market value gains.

-- \$92 million increase in capital assets represents capital projects including the Biomedical Discovery District, Northrop renovation, and the University Recreation Center.

Professor Durfee asked who decides on the change in strategy in the use of the cash accounts. OIB, Mr. Volna said. The Board of Regents sets policy; OIB is allowed to invest in certain things and to put cash into investments within the parameters set by the Board policy.

Professor Durfee asked if the capital assets category includes unfinished facilities, such as Northrop or the Nanotechnology building. Usually not, Mr. Volna said, but it depends on the type of project and other factors. Professor Zaheer asked why a market value is assigned to buildings. The Annual Financial Report uses historical cost values, but market values are also tracked so that the University has adequate insurance on them, Mr. Volna said. Professor Luepker commented that there really isn't an open market even though the University calls its buildings capital assets. Mr. Volna said the purpose for calling them capital assets is to capture the investment in them and to record that over time the investment is used up and needs reinvestment to bring it back to a usable standard (e.g., Coffman, Walter Library). The purpose of establishing a building's market value is not so the University could sell it.

Mr. Volna turned to the balance sheet overview of liabilities.

-- Total University liabilities increased by \$104 million (6%), primarily because of an increase in debt, which is managed in tandem with buildings: When buildings are built, there is usually some debt issued, and a source of payment for the debt is identified.

-- Increase in accrued & other liabilities of \$20 million is due to the gradual amortization of the OPEB (employee benefits) liability.

-- Long-term debt increased \$81 million due to issuance of 2011C / 2011D General Obligation bonds and 2011B special revenue bonds, offset by refundings and debt service payments. The special revenue bonds were for things like housing facilities, etc.

Professor Luepker asked if the cost of the new Ambulatory Care Clinic is included in these numbers. It is not, Mr. Volna said, because construction has not started on the facility and the bonds have not been issued. In the most recent plan he saw, the University will build the building and lease it and the

land to University of Minnesota Physicians (UMP) and Fairview, which will pay the University in order for it to cover the debt. So if the University were to separate from Fairview, Professor Luepker said, the University would own that portion of the debt? Mr. Volna said the University would have to figure that out as part of the current negotiations with Fairview, and he assumes the University will proceed very carefully before a shovel is put in the ground for the clinic.

Mr. Volna touched on an overview of the University's revenues, expenses, and changes in net assets; the latter increased by \$124.7 million. Accounting standards require some odd data configurations, such as counting the state appropriation more like gift income, but the bottom line looks fine, Mr. Volna told the Committee. He also noted a pie chart indicating revenues (\$3.07 billion FY 2012) and said that the University has a diverse source of revenues, most of which the institution actively manages, such as tuition and auxiliary enterprises. Similarly, there is a diversity of expenses (\$2.95 billion FY2012); if one compares the University's operating expenses year over year, one might be surprised at how well-managed expenses are; the University did a remarkable job of managing deep cuts in state appropriations.

Mr. Volna reviewed operating expense trends over five years from two different standpoints and observed that the lines on the graph are quite stable. The Committee and Mr. Volna had a somewhat technical discussion of how financial aid and fellowships are counted, and Mr. Volna concluded that it is difficult to translate the data in this report to what is happening in the colleges.

Mr. Volna explained the cash flows for FY2012 and that even though the University had less cash on hand at the end of 2012 than it did in 2011, the balance is still positive and has changed primarily because of the change in OIB strategy in the use of cash and how it gets reported in the Annual Financial Report.

Professor Zaheer recalled the recent article in the *Wall Street Journal* and said that while it was not all negative, it was nonetheless an indictment of the University. The president has said it is difficult to compare the University to other institutions because accounting practices differ. Is it worth trying to square practices so that one could get comparisons? He said he believes the University is well run and it might be worth it to get numbers so it could compare and see how it stacks up.

Mr. Volna said the suggestion is a good one and that he and his colleagues are talking with their counterparts at the University of Iowa on a pilot comparative analysis; they are taking functional line items (research, instruction, public service, institutional support, student services, etc.) apart and comparing the expenses with Iowa. They find that there are some areas that are cut and dried while others require judgment. They will focus on whether the University of Minnesota is making the same judgments as other institutions and on whether or not the expenditures are comparable (e.g., Iowa owns a hospital; Minnesota does not) and if there are differences in scale. They will take their work to the CIC when the pilot is completed. These won't be line-by-line budget comparisons but it will be useful to identify 10-12 areas that are the most subjective and learn if the institutions are making the same judgments.

Professor Durfee thanked Mr. Volna for the overview of the annual report.

## **2. Emerging Issues in Audits & Risk**

Professor Durfee welcomed Associate Vice President Klatt to the meeting to discuss emerging issues in audits and risk.

Ms. Klatt began by saying that each year her office does a multi-layered risk assessment for the purpose of informing the development of the annual internal audit plan. This process evaluates risk across the institution and its results are often of interest to others in contexts beyond that related to internal audits. (The information from the Board of Regents' docket on development of the annual audit plan is appended to these minutes.)

The risk assessment begins with an environmental scan of the University's peers and areas of regulatory interest to see if there is something they should think about.

Normally the scan does not look very different from year to year, but that was not true this year, Ms. Klatt related. The number one risk identified by higher education peers was the reputational risks associated with institutional ethical lapses (e.g., Penn State); this risk eclipsed the previous number one risk of the last few years for public institutions, declining state support. The next big risk, notable for how frequently and high-risk it was reported to be, is the impact of online learning strategies, which seemed to have replaced the risks associated with expanding the international footprint of the institutions, which was a commonly cited risk for the previous 3-5 years.

Not surprising, the top ten list of risks also includes the cost and impact of regulatory requirements; specifically data privacy, data security, export controls, and conflict of interest.

Technology continues to be a risk of concern, with two new “wrinkles” emerging. 1) institutions are challenged in managing technology as a major cost driver for institutions but also as an area where strategic investment is necessary, and 2) the challenges presented in how to provide risk management in the new environment of mobile and cloud computing—no one has identified how best to manage the risks with new devices and wireless service, but there is recognition that current models may not be effective.

Finally, a good number of institutions identified the risks of merging operations into service center models.

Regulatory controls, conflict of interest, and HIPAA and technology in the protection of personal health information concerns have been heightened by the reviews being performed by the Office of Civil Rights. A number of schools believe they could be on the list to be reviewed; the University of Minnesota could be as well.

Many regulators (e.g., Department of Defense, NIH, NSF) are moving to an auditing model based on Data Analytics in which they look at University data for anomalies that would indicate a need for an audit. These analyses can produce odd results and the audits can be very messy. Schools that have undergone audits based on data analytics have taken issue with the approach—but it is a valid auditing approach and is being more commonly used in a number of audit contexts, such as federal regulatory audits, external financial statement audits, and internal audits. The fact that the federal agencies are beginning to use the approach will require that institutions manage the audit process differently.

Do they (the federal auditors) only audit the anomalies, Professor Hupp asked? That is what they will come to do the audit on, Ms. Klatt said, but the agency can broaden the audit if something else comes to its attention as a result of their more in-depth review.

Professor Zaheer commented that some risks are low probability but high impact while some are high probability but low impact; does her office make a distinction between these kinds of risk and have different strategies for approaching them? They do, Ms. Klatt said. The audit approach will differ depending on the probability and impact ratio. For some of the risks identified in the risk assessment, a

decision is made not to provide audit coverage—primarily because the administration has not yet determined what the institutional response to the risk should be. For example, the impact of online education is a risk (and an opportunity), but the provost is still developing the institutional strategy in this area, consequently there is nothing yet concrete to audit. As a plan is developed, they can audit it.

Professor Zaheer observed, apropos of Penn State, that the event was low probability, but something can happen that has a massive impact. There is little an institution can do proactively, he said, because the probabilities are so low. So one wonders if there is a system to look at different kinds of risks and how to deal with them differently. Ms. Klatt said that while a specific situation may in and of itself be a low probability, one needs to be concerned with environmental conditions that allow the situation to occur. In the case of Penn State, the fact that there was an environment where a powerful individual was able to operate outside the institutional norms led to a bad outcome involving children—but it could be a highly renowned researcher who misuses research funding, a senior level administrator who gets "perks" on the side, a power coach who ignores NCAA rules. The important "theme" is that everyone should be held to the institution's standards. Documents such as the University's Code of Conduct help create the appropriate "tone at the top."

Professor Morrison said that one risk he has not heard mentioned is the risk of a substantial decline in federal funding. Ms. Klatt said that for other institutions, that issue seemed less on the radar than the decline in state funding. Even with the fiscal cliff and the possibility of sequester, Professor Durfee asked? State funding and the sustainability of the institutions were the primary foci of attention, Ms. Klatt affirmed. This could have been impacted by the timing of the risk assessment, which they do in the spring, which is when the states are dealing with their budgets.

Professor Luepker said that his college, the School of Public Health, could lose 20% of its funding if sequester occurs.

Professor Hupp asked when the risk data were collected. About April, Ms. Klatt said, because she makes an annual presentation to the Board of Regents in June. So in the spring, which just happens to coincide with when legislatures are in session and budgets are being set.

They also talk to institutional leaders, such as the vice presidents, the deans, and business process leaders, about where they see risks, Ms. Klatt said. The number one risk that group identified was the transition in University leadership; other issues were the restructuring of the Graduate School and its impact on the colleges, e-learning, an increased emphasis on curriculum development driven by financial rather than educational concerns, challenges in the Academic Health Center because of tuition inelasticity, and declining state funds. What was not on the list was the financial stability of the unit; the leaders had no concerns about their own unit because of reserves and revenues—so in the spring of 2012, the deans and vice presidents felt comfortable with the situation of their units. Ms. Klatt said she would have expected to hear more uncertainty.

They talk with the leadership of the Board of Regents (the chair, vice chair, and committee chairs). Board members believe the University must significantly improve its human resources processes; they are not seen as efficient or as managing human resources well. Professor Durfee asked if the concern is about people or processes; the latter, Ms. Klatt replied, including the infrastructure, administration of resources, and institutional policies.

The Board members were also very concerned about the risk that Board policies are not being adhered to (a concern prompted by the broad interpretation given to the policy about administrative severance and leaves). The Board also wants to be sure that the risks in the relationship with Fairview are

properly managed. They were also concerned about the risks of decentralization, of tuition policy (high tuition, high aid, and the differences between resident and non-resident tuition), and the transition in the leadership team.

The results of the risk assessment are communicated to the Audit Committee of the Board of Regents. They (the Office of Internal Audit) also try to keep a finger on the pulse of things that come up during the year that were not expected or contemplated when the assessment was completed, Ms. Klatt said. On the latter list include the Fairview relationship/the Ambulatory Care Clinic/the enterprise system update/ the merger of the foundations.

Professor Zaheer said that in his field, they distinguish between risk and uncertainty. The uncertainties cannot be parametrized; with the risks, it is possible to identify probabilities and a set of outcomes associated with each. Does her office do that same kind of analysis or do they simply say that there is a risk? Or do they do a probability distribution and the risks associated with each? Ms. Klatt said that they consider emerging risks to be uncertainties—they do not know what the specific risks are. Once they know, they can do a risk assessment and compare those risks against the other risks being managed by the University, and while they use the framework Professor Zaheer alluded to (considering likelihood and impact), it is not especially scientific. They would not assess a risk at a 69% or 75% level, for example, they would try to determine if it is more likely than not that a risk will manifest itself.

Her office has no auditing responsibility for either the University of Minnesota Foundation or the Minnesota Medical Foundation, but the merger of the two organizations is important to the University's success and the Board of Regents will want it to be an operational success.

With respect to administrative cuts, those are related to the risks identified in the environmental scans that are associated with external reporting of data, Ms. Klatt said. Law schools and the University of Illinois reported inaccurate data, and while not intentional, the inaccuracies caused major problems. The institution must have confidence in the data it reports and how it is interpreted. There is an expectation that the federal government will start establishing performance measures that universities will need to report on; how prepared are they (and we) to do so?

The enterprise system upgrade, at \$83 million, is a significant risk that will draw a lot of resources from units, Ms. Klatt cautioned. The project will take two and one-half years and units will feel the effects of the demands on their resources.

An operational risk assessment across the University gives them a list of high- to low-risk units, Ms. Klatt said, and provides an indication of where they should spend their time.

Professor Schultz recalled recent news about the declining number of college-age students; do they look at that? They do, Ms. Klatt said, and also whether the University is modifying its recruiting practices given the growing populations of students of color (in a recent audit of admissions they found that the University is doing a good job on that score).

Professor Feeney asked if, apart from cyclic and emerging risks, they have a policy of routine audits of some units, such as Human Resources, Sponsored Projects Administration, and so on. Do they have some kind of internal quality assurance mechanism? The audit plan used to be about 70% units and 30% process, Ms. Klatt responded, and they would audit the high-risk units every three years. They have moved away from that practice because while it provides information at the unit level, with a decentralized institution risk is spread across the University. If they audit a unit and find 5 out of 50 items are not in compliance with policy, does that mean the University has a 10% institutional non-

compliance rate? In order to obtain enough information to reach a conclusion, they would have to conduct many more audits and the numbers would get old before they could finish. So they changed their approach to process audits, which looks at an activity, say Accounts Payable, across the entire institution. This allows them to draw statistically valid sample sizes that enable them to reach an institutional conclusion. If they find a 96% compliance rate, for example, in Accounts Payable processing they can conclude that the process is working well. So now they would like the balance to be 60% process audits and 40% unit audits.

Professor Luepker commented that Ms. Klatt had mentioned things that he had never even thought to worry about before her remarks. In terms of high tuition/high aid, what is next? Is she the messenger at the gate? Will the Regents look at the issue? In that case, Ms. Klatt explained, some of the risks identified by risk assessment are not dealt with by the auditing department—but someone must deal with them. This risk was identified by Board leadership in her discussions with them and they have in fact included it on their work plan for the year.

Professor Morrison asked if high tuition/high aid should be on the Committee's agenda. Professor Durfee said he thought it should and agreed to schedule it.

Professor Durfee inquired about reputational risk and ethical lapses. How do they audit for that risk at the University? Ms. Klatt said they do not audit it per se; they look at the situations that come up during an audit and ask how it was responded to. If there is an institutional culture that says those lower in the organization are held to a higher standard of behavior than those in the upper levels, there is a problem. They want to see a culture where, if someone violates a policy, they are held accountable across the institution irrespective of level in the organization. Professor Durfee asked if it is correct that in order not to be reactive, the auditors must look across the institution, even if events are low probability. It is, Ms. Klatt said, but the idea is if an individual can trump University policies and procedures, the outcome for the University is not likely to be good.

What are the implications of the events at Penn State, Professor Durfee asked? Their administrative costs will go up, Ms. Klatt said, and they are revamping a great deal. They had no formal compliance program, and one is now being established; they are adding auditors. There are recommendations that they reconstitute their governing board; she is not sure where they are at on that, but some committees have been assigned additional oversight responsibilities (i.e., the Audit Committee). But they had an increase in admissions applications; Ms. Klatt said she did not know why. Morale has suffered; this type of situation sucks the life blood out of an institution. They had a shaky relationship with their state legislature and this has not helped. The former executives still face trials, so there continues to be uncertainty. The negative effects of a major lapse on an institution include people feeling violated and that their trust was misplaced. The implications are broad, Ms. Klatt said, and can be very long lasting.

Professor Luepker asked who is paying the legal costs for the former Penn State officials. Ms. Klatt said she believes that Penn State is, because the actions were in the context of their work, and the President had publically stated his support and belief that they had appropriately carried out their duties; that would also likely be true at the University of Minnesota. Professor Morrison said this has been an issue around the University over a number of years: At what point will the University abandon an individual? At the point of final judgment or at the point of accusation? Ms. Klatt suggested the Committee direct that question to General Counsel Mark Rotenberg. The issue has been a source of tension between Mr. Rotenberg and the Committee, Professor Morrison said.

Dr. Fitch asked what the chances are that Data Analytics analysis would trigger a federal audit of the University. This is a process that is really new on the radar screen for research universities, Ms. Klatt said, and COGR (Council on Government Relations, an association of research universities of which the University is a member ) has advised its members to look at Data Analytics and is gathering information about the triggers so that institutions can be prepared. She has been thinking about whether it would be cost effective for the University to have its own analytics program to alert it to potential bumps in the road that could be taken care of. She has not done the cost/benefit analysis and is still thinking about it as more information on the federal programs is made available. (The Office of the Vice President for Research does do monitoring for exception situations and this might be sufficient.)

Professor Zaheer asked how they benchmark their duties—who audits the auditing function? They do it quite a bit, Ms. Klatt said. They must follow professional standards in their auditing work and they are required to have an external peer review every five years to make sure they are in compliance with standards. They use these reviews to have their practices evaluated against the best practices of the profession. She said that the University is seen as a leader. They also benchmark against best practices using other mechanisms; they benchmark against the Big Ten, the rest of higher education, and other industry sectors—in the case of the last, because they believe they can learn from what the private sector is doing.

Professor Zaheer said it is not just a matter of numbers; do they do scenario planning? Consider what likelihood that something might become reality? How do they create robust strategies to make the University come out whole in each case? Is there a process to identify the likelihood of different scenarios and information to the administration on implementing strategies? Ms. Klatt said they do scenario assessment of the likelihood of fraud occurring in a unit, and develop appropriate audit mechanisms to evaluate the controls in place to reduce the risk. They also look at vulnerabilities in information technology, etc. and build audit procedures to evaluate their mitigation. They do not do other scenario projections—that is not really their role nor is it what the Board of Regents expects from them, but it could be a valuable tool for the administration to consider using.

Professor Morrison thanked Ms. Klatt and observed that she comes from the Department of Scary Things. Professor Durfee extended his thanks for the conversation with the Committee.

### **3. Bank Cards**

Professor Luepker noted a recent article in the newspaper about bank cards; Professor Durfee asked if the Committee wished to receive information about the nature of the University's contract with TCF. Committee members indicated they did; Professor Durfee said he would obtain the information.

Professor Durfee adjourned the meeting at 4:00.

-- Gary Engstrand

University of Minnesota

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**Excerpt from the Board of Regents Audit Committee Docket – June 2012**

**DEVELOPMENT OF THE ANNUAL PLAN**



The development of the annual audit plan is based on information gathered through broad consultation across the University and a formal assessment of existing and emerging risks.

### **Internal Risk Assessment**

As part of the planning process, discussions were held with 94 institutional officials from 43 units to solicit input on the University's institutional risks and any specific areas of concern. We also used these meetings as an opportunity to obtain feedback on the quality of audit services we provide. Common themes expressed in these discussions this year were:

- The continued transitions in University leadership
- Graduate School restructuring and the impact on the colleges
- E-learning strategies
- Curriculum development that is driven by financial versus academic needs
- Authorized enrollment increases being impeded by space limitations and faculty recruiting challenges
- Financial challenges in the health sciences caused by tuition inelasticity and reduced state funding.

We also held risk discussions with the Chairs and Vice Chairs of the Board of Regents committees, along with the Chair of the Board. The risks of greatest concern for governance are: the need for improvements in the University's Human Resources processes; assurance that Board of Regents policies are being adhered to consistent with Regental intent; the University's relationships with Fairview Health Services and University of Minnesota Physicians; the degree of decentralization within University operations; tuition philosophy; graduation rates; and, the successful transition of the University's leadership team.

### **External Risk Assessment**

To aid in our planning efforts we use a survey of other research universities regarding the assessment of risks within their institutions. While all of the public universities surveyed reported declining trends in state support as a significant concern, it is very interesting that the risk most consistently reported of greatest concern was the reputational risk associated with ethical lapses. The strategic risks presented by on-line education were also prominent in the survey responses, virtually replacing international risks which were front and center only two years ago. Not unexpectedly, the increasing cost and burden of regulatory compliance was commonly cited, especially in the areas of data privacy, data security, export controls, and new conflict of interest regulations. Additional areas where significant audit attention is being given include: social media, mobile device security, cloud computing, and integration of service center operational structures.

### **Operational Risk Assessment**

Finally, our annual planning process includes re-examining the audit universe to ensure that all university activities are considered when determining how audit resources will be allocated. We also consider new regulatory developments, new business processes, and institutional priorities and strategic initiatives.

The Office of Internal Audit continues to utilize a formalized risk assessment methodology in selecting processes/units/systems for inclusion in the annual audit plan. Relative risk assessment is necessary to provide a basis for the rational deployment of our limited resources across the institution. The risk factors that we considered in prioritizing institutional activities are:

- Impact on the University's mission
- Impact on University finances
- Assessment of the activity's control environment
- Level of compliance concerns
- Impact of information technology
- Complexity and/or diversity of the activity
- Changes in the organization or leadership

Our operational risk assessment resulted in a risk ranking of 162 individual auditable activities of which 23 are considered to be high risk, 95 moderate risk, and 44 low risk. A rating of "high-risk" does not mean that the activity is perceived to have control problems, but rather reflects the criticality or centrality of the activity to the University's mission.

#### **OVERALL RISK ASSESSMENT**

Taking into account the information we obtained in our risk assessment process, the proposed 2013 audit plan focuses on high risk process audits in the financial, research, and technology areas. Selected human resources processes will also receive audit coverage. Because of the number of new senior leaders and additional planned transitions, we believe that it is especially important for the audit plan to be highly flexible for the upcoming year. As leaders become more familiar with their portfolios, and further define their priorities, it may be appropriate to adjust the audit plan to align with these priorities. Additionally, several key areas were identified during our risk assessment process which we feel are not sufficiently developed to warrant inclusion in the audit plan at this time. However, if significant progress is made in these areas (on-line education strategies, the Ambulatory Care Center, the Clinical and Translational Science Institute [CTSI] and Solutions for Integrated Research Compliance [SIRC] systems, enterprise security framework, and IT governance) adjustments to the audit plan may be appropriate.