

**MINUTES OF THE AUDIT AND COMPLIANCE SUBCOMMITTEE
OF THE FINANCE COMMITTEE
University of Kentucky Board of Trustees
April 1, 2014, 9:00 am
Suite A, 18th Floor Patterson Office Tower**

Subcommittee Members Present

James Stuckert, Acting Chair, Jim Booth, Angela Edwards and Keith Gannon

Approval of Minutes

The minutes of the January 31, 2014 Audit and Compliance Subcommittee (ACS) meeting were approved as presented.

Reports and Discussion Items

BKD FY 2014 Scope Review and Effect of Recent GASB Pronouncements

Ms. Joanie Duckworth, BKD Supervisor, reviewed the *Pre-Audit Report to the Audit and Compliance Subcommittee* and highlighted the following items:

- entities included in the FY 2014 audit
- the planned scope and timing
- preliminary risks identified which were similar to last year and new items including
 - the adoption of Governmental Accounting Standards Board (GASB) Pronouncement No. 65, *Items Previously Reported as Assets and Liabilities* for the FY 2014 financial statements and
 - the reporting of Eastern State Hospital activity by the UK HealthCare Hospital System, namely the management fee income and associated expenses incurred.

Ms Mary McKinley, BKD Partner, gave the presentation: *Effect of Recent GASB Pronouncements*. She reviewed six new GASB Pronouncements and their respective impact on the University's financial statements this year and ongoing years. Discussion followed.

UK Internal Audit (UKIA) Update

Mr. Joe Reed, Internal Audit Senior Director, reported on the following:

- FY 2014 Comply Line Summary Update:
 - He noted that as of January 31, 2014, 99 calls had been received; 14 were duplicate calls, 21 were general calls and 64 reportable calls.
 - The calls were summarized by Area of Concern and Enterprise Division to enable UKIA to trend the data and give the University adequate audit coverage.
 - Mr. Reed gave an overview of how the University Comply Line operates and handles calls.
- FY 2014 Activity Update as of January 31, 2014:
 - Mr. Reed noted that the first quadrant represents the FY 2014 UKIA Approved Work Plan providing a status of each audit project. He mentioned that the Work Plan was amended at the January 31, 2014; the amended Work Plan will be reflected in his UKIA activity update at the May ACS meeting.
 - Mr. Reed reported that the second quadrant represents the FY 2014 Unplanned Reviews. UKIA spent 42% of our time on unplanned activity in the second quarter for FY 2014; as of the end of the fiscal year, that percentage is projected to be around 35%.
 - Mr. Reed reviewed the third quadrant that lists the FY 2014 UKIA Audit Coverage by Enterprise Division, including the number of projects and project hours.

- The fourth quadrant lists the FY 2014 UKIA Metric Update. Mr. Reed reported that UKIA is achieving five of the six metrics as of January 31, 2014. The Work Plan Completion metric is not being achieved due to unplanned activity; the rate will be adjusted to reflect the amended Work Plan.
- UKIA's Unannounced Cash Audit Program:
 - Mr. Eric Monday, Executive Vice President for Finance and Administration, requested that Mr. Reed give an overview of the unannounced cash audits that are performed by UKIA, noting that the program was distinctive. Mr. Reed reported that other universities around the Commonwealth are looking to replicate this program. University units are selected using such criteria as the number of voided receipts and the last time any audit was performed in the unit, among others. UKIA arrives at the unit unannounced and conducts the cash audit in 2-3 hours using the same audit program for all units to allow for trending across the entire enterprise division. In 30-90 days, UKIA will conduct a follow up review to see if the findings have been resolved.

There being no further business, the meeting was adjourned.

Next Meeting

Friday, May 9, 2014

- Internal Audit Risk Assessment Review for FY 2015 Work Plan
- Internal Audit Charter Revision Draft

Respectfully submitted,

Catherine Miller

University of Kentucky

Pre-Audit Report to the Audit and Compliance Subcommittee

April 1, 2014



Contents

Introductory Matters	1
Planned Scope and Timing of the Audit	2
Auditing and Accounting Matters	5
Consideration of Errors or Fraud	6
Questions, Observations or Suggestions From the Audit and Compliance Subcommittee	7

Introductory Matters

The purpose of this report is to summarize various matters relating to our approach for the June 30, 2014, audit of the financial statements of the University of Kentucky (UK) and its subsidiaries.

Audits of Financial Statements

We will conduct our audits in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Audit Standards* issued by the Comptroller General of the United States and U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Our audits will be made for the purpose of rendering opinions on the following financial statements as of and for the year ended June 30, 2014:

- ✓ UK
- ✓ UK Healthcare Hospital System (Hospital)
- ✓ UK Department of Intercollegiate Athletics
- ✓ WUKY – FM Radio

Our engagement also includes audits of the financial statements of the following entities, which are communicated in separate pre-audit reports to the governance of those respective entities:

- ✓ UK Research Foundation
- ✓ The Fund for Advancement of Education and Research in the UK Medical Center

Our audit focuses on the likelihood of a material misstatement in the financial statements.

- ✓ Central Kentucky Management Services, Inc.
- ✓ UK Mining Engineering Foundation, Inc.
- ✓ UK Gluck Equine Research Foundation, Inc.
- ✓ UK Humanities Foundation, Inc.
- ✓ UK Center on Aging Foundation
- ✓ Kentucky Tobacco Research and Development Center

An audit of the financial statements does not relieve management or the audit and compliance subcommittee of their responsibilities.

Other Services

Other services we will provide include:

- ✓ Audit of the Schedule of Expenditures of Federal Awards
- ✓ Preparation of annual bond arbitrage calculations
- ✓ Agreed-upon procedures in accordance with the NCAA's Financial Audit Guidelines
- ✓ Attestation report on the Annual Financial Report to the Corporation for Public Broadcasting for WUKY – FM Radio

The actual terms of our engagement are more fully documented in an engagement letter dated December 23, 2013, and signed by you and BKD.

Our audit approach emphasizes the areas of higher risk, focusing on the unique characteristics of the operating environment, the effectiveness of your internal control and your financial statement amounts and disclosures.

Based on our understanding of UK and our assessment of your internal control, we plan our audit to achieve the appropriate level of assurance regarding material misstatements and material weaknesses in internal control over financial reporting.

Planned Scope and Timing of the Audit

We have preliminarily identified the following areas as significant risks of material misstatement due to error or fraud and propose to address these areas as described:

Risk Area	Audit Approach
<u>UK and Affiliates</u>	
Risk of management override of controls	Review accounting estimates for bias, review of journal entries, evaluate business rationale for unusual transactions
Self-insurance for medical malpractice, long-term disability, workers' compensation, health insurance and litigation reserves	Review management's estimates for self-insurance and test of completeness of liabilities
Valuation of alternative investments	Confirm investment balances and test selected investments accounts
Allowance for doubtful accounts and pledges receivable	Test management's assertions with respect to the calculation of uncollectible accounts
Adoption of GASB No. 65 – <i>Items Previously Reported as Assets and Liabilities</i>	Test management's calculation and recording in regard to the adoption of GASB No.65
<u>UK Healthcare Hospital System</u>	
Recording of activity related to Eastern State Hospital	Review the agreement and accounting with respect to Eastern State Hospital and UK Healthcare Hospital System

Risk Area	Audit Approach
Contractual allowances and amounts due to/from third-party payers	Test management's assumptions and estimates included in the contractual allowances and amounts related to cost reports
<p>We welcome any input you may have regarding the risk areas identified above, any other significant risk areas in your opinion or other matters you believe warrant particular attention during the audits.</p>	
<p>We may identify additional significant risks as we complete risk assessment procedures.</p>	
<p>We propose the following timeline:</p>	
<p>✓ Final Reports – October 3, 2014</p>	
<p>Final reports to the audit and compliance subcommittee will be issued prior to the Commonwealth of Kentucky's reporting deadline of October 3, 2014, which is prior to the December 2014 scheduled meetings of the audit and compliance subcommittee and board of trustees.</p>	
<p>✓ Ongoing Communication</p>	
<p>Regular communication between the audit and compliance subcommittee and the auditors is critical to the success of the audit. Accordingly, the audit team may be available to the audit and compliance subcommittee and board of trustees at any time throughout the audit, not just the prescribed times identified above. In addition, there may be instances which require communication during the audit (prior to delivery of the financial statements) such as:</p>	
<ul style="list-style-type: none"> • Fraud involving senior management • Illegal acts • Significant deficiencies and/or material weaknesses • Material instances of noncompliance for federal award programs 	

Auditing and Accounting Matters

We understand the appropriate person in the governance structure with whom to communicate is Mr. Bill Britton.

If for any reason, any member of the audit and compliance subcommittee would need to contact us, please call Mary McKinley at 502.581.0435.

We wish to communicate the following significant matters related to the financial statement audit to you that are, in our judgment, relevant to your responsibilities in overseeing the financial reporting process:

Critical Accounting Policies and Practices

- ✓ No matters are reportable.

Alternative Treatments of GAAP

- ✓ No matters are reportable.

New Audit Techniques to be Applied

- ✓ No matters are reportable.

Critical Audit Areas

- ✓ No matters are reportable.

Locations to be Visited and Scope of Audit Work at These Locations

- ✓ UK, UK Hospital and affiliates' accounting departments.

Unusual Accounting Matters

- ✓ No matters are reportable.

New Accounting Pronouncements

- ✓ GASB No. 65, *Items Previously Reported as Assets and Liabilities*

Consideration of Errors or Fraud

Reliance on Internal Audit

- ✓ We will review internal audit's work plan and all internal audit reports issued during the year ending June 30, 2014, to assist us in identifying risk areas, and to possibly place reliance upon internal audit's work to reduce our detailed testing procedures. We will not utilize internal audit staff to provide direct staffing assistance to us during our auditing procedures.

One of the most common questions we receive from boards of trustees is, "How do you address fraud in a financial statement audit?" Our responsibility, as it relates to fraud, in an audit of financial statements is addressed in auditing standards generally accepted in the United States of America.

Our audit approach includes such procedures as:

✓ Engagement Team Brainstorming

- Discussions include how and where they believe UK's financial statements might be susceptible to material misstatement due to errors or fraud, how management could perpetrate and conceal fraudulent financial reporting and how assets of UK could be misappropriated
- An emphasis is placed on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to errors or fraud

✓ Inquiries of Management and Others

- Personnel interviewed include the audit and compliance subcommittee chair, president, treasurer, provost, controller and others
- Inquiries are directed towards the risks of errors or fraud and whether personnel have knowledge of any fraud or suspected fraud affecting UK

**Questions,
Observations or
Suggestions from the
Audit and
Compliance
Subcommittee**

- ✓ **Reviewing Accounting Estimates for Bias**
- ✓ **Evaluating Business Rationale for Significant Unusual Transactions**
- ✓ **Incorporating an Element of Unpredictability Into the Audit Each Year**

At this time, we would certainly welcome any additional questions that the audit and compliance subcommittee or board of trustees may have. As always, you may also contact Mary McKinley at 502.581.0435 at any time.

Our clients deserve and to the best of our ability receive unmatched client service. We welcome the opportunity for you to experience the same as we deliver the services outlined above.

Our goal is to deliver results with integrity: results that are unquestionably ethical while also practical, timely and affordable.



CPAs & ADVISORS

experience **perspective** //

EFFECT OF RECENT GASB PRONOUNCEMENTS

April 1, 2014



DISCUSSION

- // GASB No. 60 – *Accounting and Financial Reporting for Service Concession Arrangements*
(Effective for fiscal year ended June 30, 2013)
- // GASB No. 65 – *Items Previously Reported as Assets and Liabilities*
(Effective for fiscal year ending June 30, 2014)
- // GASB No. 68 – *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27* *(Effective for fiscal year ending June 30, 2015)*
- // GASB No. 71 – *Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68* *(Effective for fiscal year ending June 30, 2015)*
- // GASB No. 69 – *Government Combinations and Disposals of Government Operations*
(Effective for fiscal year ending June 30, 2015)
- // GASB No. 70 – *Accounting and Financial Reporting for Nonexchange Financial Guarantees*
(Effective for fiscal year ending June 30, 2014)





GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

Decision tree/flowchart – all yes = service concession arrangement

1. Right/obligation to provide service in exchange for consideration?
2. Public asset used?
3. Operator compensated by service recipients?
4. Transferor exercises control over services, recipients and rates?
5. Transferor retains significant residual interest in asset?

GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

// Education Realty Trust (EdR) Contract Phase I

// Agreement overview

// Dorms opened in August 2013

// Initial 50-year term for lease of land to EdR

// 1st renewal – 10 years – UK required to purchase dorms at fair market value, unless 2nd renewal option exercised

// 2nd renewal option – 15 years – UK required to purchase dorms for \$10

// Considered for GASB 60 accounting treatment; however, as title to the halls does not transfer to UK at the end of the **initial lease term, GASB No. 60 is not applicable**

// In FY '13 -'14, UK began recording ground lease revenues from EdR under an operating lease arrangement

GASB 60 – ACCOUNTING AND FINANCIAL REPORTING FOR SERVICE CONCESSION ARRANGEMENTS

- // Education Realty Trust (EdR) Contract Phase II
 - // Agreement overview
 - // Multiple projects – 1st dorm to open in August 2014
 - // 75-year term for lease of land to EdR
 - // UK to immediately take title to dorm buildings upon construction completion
 - // GASB 60 accounting treatment is applicable
 - // In FY '14 -'15, UK will record
 - // The cost of the buildings and furnishings as an asset (approximately \$133 million)
 - // Accrued liabilities for insurance on the assets (approximately \$5 million)
 - // Deferred inflows for service concession arrangements (approximately \$128 million)
 - // In FY '14 -'15 and in future years, UK will record depreciation on the building and furnishings (75 years); and will record amortization on the service concession amount (75 years)
 - // Furnishings will be continually replaced over 75 year term
 - // Depreciation expense (debit to financial statements) will = amortization of service concession “income” (credit to financial statements)



GASB NO. 65 – ITEMS PREVIOUSLY REPORTED AS ASSETS AND LIABILITIES

- // Effective for June 30, 2014 financial statements
- // Retroactive application required – Restated financial statements
- // Debt issuance costs previously recorded as assets, will be written off to expense (approximately \$3.7 million at July 1, 2012)
- // Deferred losses on debt defeasances reclassified from debt line item to deferred outflow line item
- // Advance-funded grants containing only time restrictions, will be recorded as deferred inflows



GASB NO. 68 – ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS—AN AMENDMENT OF GASB STATEMENT NO. 27

- // Effective for June 30, 2015 financial statements
- // Retroactive application required – Restated financial statements
- // Primarily affects multi-employer defined benefit plans (*e.g.*, KTRS, KERS)
 - // Pension expense reported as employees earn benefits by providing services
 - // If unfunded amount, statements report a **net pension liability**
- // UK has defined contribution pension plan
- // Regional universities, state government, others will record significant liabilities upon adoption



GASB NO. 71 – PENSION TRANSITION FOR CONTRIBUTIONS MADE SUBSEQUENT TO THE MEASUREMENT DATE

- // Required to be applied simultaneously with the provisions of Statement 68
- // Amends paragraph 137 of Statement 68 – At the beginning of the period in which the provisions of 68 are adopted, there may be circumstances in which it is not practical for a government to determine the amounts of ALL applicable deferred inflows of resources and deferred outflows of resources related to pensions. In such circumstances, the government should **recognize a beginning deferred outflow of resources only for its pension contributions, if any, made subsequent to the measurement date of the beginning net pension liability but before the start of the government’s fiscal year.**



GASB NO. 69, GOVERNMENT COMBINATIONS & DISPOSALS OF GOVERNMENT OPERATIONS

// Effective for June 30, 2015 financial statements

// Acquisitions

// Record at acquisition values

// Consideration > assets/liabilities = deferred outflow

// Net position > consideration

// Reduce acquisition values of noncurrent assets acquired or contributed

// Remaining excess recognized as a special items



GASB 70 – ACCOUNTING AND FINANCIAL REPORTING FOR NONEXCHANGE FINANCIAL GUARANTEE TRANSACTIONS

- // Effective for June 30, 2014 financial statements
- // Requires a government that extends (or receives) a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not the government will be required to make a payment on the guarantee.
- // A **Nonexchange Financial Guarantee** is a guarantee of an obligation of a legally separate entity or individual, including a blended or discretely presented component unit, which requires the guarantor to indemnify a third-party obligation holder under specified conditions.

**FY 2014 Comply Line Calls
Mid-Year Summary**

<u>Call Type</u>	<u>Number</u>	<u>Definition</u>
Total	99	All calls / emails to Comply Line are reported to the University.
Duplicate	14	Caller(s) is following-up regarding previous call(s). These calls are not included in detail below.
General	21	Caller(s) is requesting or providing information regarding general matters.
Reportable	64	Caller(s) is reporting a concern that requires action or follow-up.

GENERAL COMPLY-LINE CALLS

Area of Concern	Academics	Finance and Administration	Administration	HealthCare	Campus Operations	Unknown	Total	Comments / Concerns
General	2		6	4	3	6	21	Policy guidance, ticket information, protocol for reporting concerns and wrong number(s)

REPORTABLE COMPLY-LINE CALLS

Area of Concern	Academics	Finance and Administration	Administration	HealthCare	Campus Operations	Unknown	Total	Comments / Concerns
Sensitive Information			1	7			8	Discussing and accessing HIPAA records
Compensation				5		1	6	Compensation for testing and screening, Unit procedures and possible employee violation
Work Environment	5	1		15			21	Unprofessional Unit practices, possible harrasment allegations, and not promoting fair / ethical work environment
Employee Concern				9			9	Possible inappropriate and unprofessional employee behavior
Human Resources				2			2	Allegations of improper Unit hiring practices
Patient Concern				14			14	Reporting of incidents
Substance Abuse				3			3	Allegations of employee substance abuse
Vendor Concerns				1			1	Concerns for improper bid award
TOTAL REPORTABLE CALLS	5	1	1	56	0	1	64	

UK Internal Audit (UKIA) Update for FY 2014 (as of 1-31-2014)

Not Engaged	In Progress	Reporting Phase	Report Issued	Metric Achieved	Metric Not Achieved
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FY 2014 UKIA Approved Work Plan		
Compliance Program		
1	Continuous Auditing	
2	Continuous Audits	
Business/Operations Audits		
3	College of Engineering	
4	Pharmaceutical Management	
5	Undergraduate Education	
6	FERPA (Family Education Rights & Privacy Act)	
7	Athletics	
7	Student Affairs	
8	Center for Excellence in Rural Health	
9	Student Financial Aid	
10	Hospital Cash Operations	
11	Grants	
12	Follow-up Audits	
Information Technology Audits		
11	Research (UKRF)	
12	HIPAA	

FY 2014 UKIA Unplanned Reviews		
1	Lockbox Inventory	
2	Document Retention (5 projects)	
3	Procard Process (2 projects)	
4	Fundraising Process (2 projects)	
5	Operational Efficiency (2 projects)	
6	Business Continuity Plan	
7	Account Reconciliation	
8	Integrated Business Units	
9	Pledges	
10	Supply Center Emergency Purchase Orders	
11	PAR Process	
12	Mining Engineering Department	
13	UK Program for Bioethics	
14	College of Dentistry Billings & Collections	
15	HR Compensation	
16	Donovan Fellowship	
17	Other External Activities	
18		

FY 2014 UKIA Audit Coverage By Enterprise Division		
Academic Coverage		
Number of Reviews, Committees, Consultations	11	
Project Hours	3,375	
UK HealthCare		
Number of Reviews, Committees, Consultations	15	
Project Hours	1,059	
Finance and Administration		
Number of Reviews, Committees, Consultations	22	
Project Hours	1,552	
Campus		
Number of Reviews, Committees, Consultations	13	
Project Hours	656	
UK Administration (Includes Athletics)		
Number of Reviews, Committees	7	
Project Hours	603	
Affiliates		
Number of Reviews, Committees	2	
Project Hours	54	

FY 2014 UKIA Metric Update	
Productivity	
Goal @ 75%	
Performance @ 83% (7,991 Direct Hours; 9,631 Total Hours)	
Infrastructure	
Hours vs. Direct Hours - Goal @ 5% of Direct Hours	
Performance @ 9% (Infrastructure 692 Hrs; 7,991 Direct Hrs)	
Recommendations Accepted (Requiring Management Response)	
Goal @ 75%	
Performance @ 100%	
Survey Results	
Goal @ 3.0 (average scale 1 is not satisfied and 4 is very satisfied)	
Performance @ 3.21 average	
Audit Duration	
Goal @ 6 - 12 weeks	
Performance @ 4 weeks	
Work Plan Completion Rate	
Goal @ 100%	
Performance @ 8%	