

University of Kentucky

Pre-audit Report to the Audit and Compliance Committee

April 2019



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Introductory Matters

The purpose of this report is to summarize various matters relating to our approach for the June 30, 2019, audit of the financial statements of the University of Kentucky (UK) and its affiliates.

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 Auditing Standards* issued by the Comptroller General of the United States and Title 2 U.S. *Code of Federal Regulations (CFR) Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those 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 ending June 30, 2019:

- UK
- UK HealthCare Hospital System (Hospital)
- WUKY – FM Radio
- Kentucky Tobacco Research and Development Center

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
- Central Kentucky Management Services, Inc.
- UK Mining Engineering Foundation, Inc.
- UK Gluck Equine Research Foundation, Inc.
- UK Humanities Foundation, Inc.

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

Planned Scope & Timing of the Audit

An audit of the financial statements does not relieve management or the audit and compliance committee 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
- Attestation report on compliance with Kentucky's Lease Law
- Agreed-upon procedures in accordance with the contracts for UK's management of Eastern State Hospital (ESH) and Central Kentucky Recovery Center (CKRC)
- Agreed-upon procedures related to contract between Kentucky Medical Services Foundation (KMSF) and UK
- Attestation report on UK's financial data and information for the Commonwealth's Annual Financial Report (state consolidation package)
- Report on compliance with House Bill 622

The actual terms of our engagement are more fully documented in an engagement letter 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.

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 journal entries and evaluate business rationale for significant transactions
Improper revenue recognition	Perform revenue cutoff testing, review journal entries and perform analytical procedures on account balances
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 investment accounts
Allowance for doubtful accounts and pledges receivable	Test management's assertions with respect to the calculation of uncollectible accounts
Compliance with Uniform Guidance	Test research and development and other major programs
<u>UK HealthCare Hospital System</u>	
Contractual allowances and amounts due to/from third-party payors	Test management's assumptions and estimates included in the contractual allowances and amounts related to cost reports

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.

We may identify additional significant risks as we complete risk assessment procedures.

We propose the following timeline:

✓ **Final Reports – October 4, 2019**

Final reports to the audit and compliance committee are planned to be issued prior to the Commonwealth of Kentucky’s reporting deadline of October 4, 2019, which is prior to the December 2019 scheduled meetings of the audit and compliance committee and board of trustees.

✓ **Ongoing Communication**

Regular communication between the audit and compliance committee and the auditors is critical to the success of the audit. Accordingly, the audit team may be available to the audit and compliance committee 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:

- Fraud involving senior management
- Illegal acts
- Significant deficiencies and/or material weaknesses
- Material instances of noncompliance for federal award programs

We understand the appropriate person in the governance structure with whom to communicate is Mr. Claude A. “Skip” Berry, III.

If, for any reason, any member of the audit and compliance committee would need to contact us, please call Mary McKinley at 502.963.0854

Auditing & Accounting Matters

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 Generally Accepted Accounting Principles**

- 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

✓ **Reliance on Internal Audit**

- We will review internal audit's work plan and all internal audit reports issued during the year ending June 30, 2019, 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.

✓ **New Accounting Pronouncements**

The following new accounting pronouncements will be effective for UK as indicated below:

- Governmental Accounting Standards Board (GASB) No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements* (FY 2019)

Consideration of Errors or Fraud

- GASB No. 83, *Certain Asset Retirement Obligations* (FY 2019)
- GASB No. 84, *Fiduciary Activities* (FY 2020)
- GASB No. 87, *Leases* (FY2021)
- GASB No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period* (FY 2021)

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 the entity 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 committee chair, president, executive vice president for finance and administration, treasurer, provost, controller, director of internal audit 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

✓ **Reviewing Accounting Estimates for Bias**

✓ **Evaluating Business Rationale for Significant Unusual Transactions**

✓ **Incorporating an Element of Unpredictability into the Audit Each Year**

**Questions,
Observations or
Suggestions**

At this time, we would certainly welcome any additional questions that the audit and compliance committee may have. As always, you may also contact Mary McKinley at 502.963.0854 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.