



1111 Franklin Street
Oakland, CA 94607-5200
Phone: (510) 987-9074
<http://www.ucop.edu>

April 5, 2017

Ms. Elaine M. Howle
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, California 95814

State Auditor Howle:

I write to respond to your draft audit report for the University of California Office of the President's (UCOP) administrative expenditures. The recommendations to UCOP are helpful. We welcome this constructive input, which align with our proactive efforts to continually improve UCOP's operations, and UCOP intends to implement the recommendations. Before turning to discussing the recommendations, I would like to clarify some other important points.

First, beginning with its subtitle, the report fundamentally and unfairly mischaracterizes UCOP's budget processes and practices in a way that does not accurately capture our current operations nor our efforts and plans for continued improvement. The report falsely claims that UCOP failed to disclose "tens of millions in surplus funds" and that UCOP's "budget practices are misleading." In fact, **UCOP's budget and financial approaches reflect strategic, deliberate, and transparent spending and investment in UC and State priorities.**

During my time as President, I have instituted measures to ensure UC's resources are carefully managed and deployed for mission-critical investments, while being transparent and accountable to The Regents and our many important stakeholders. I require and expect this office to continually improve its performance, processes, and services, while simultaneously evaluating ways to cut costs. Both efforts are integral to the operation of a world-class university system and its fundamental missions of teaching, research and public service. At the same time, I realize no organization is perfect. This audit is a chance to welcome feedback and build upon our already significant progress.

Second, the report asserts that UCOP "amassed more than \$175 million in reserve funds" and raises associated concerns about the management and transparency of those funds. I disagree with all of these assertions.

To start, the **\$175 million figure mischaracterizes the true amount of UCOP's available and uncommitted reserve, which is \$38 million, a modest amount for an organization our size.** Moreover, the \$175 million amount cited should actually be \$170 million, as \$5 million is not UCOP-related fund balance data.

Of that \$170 million, \$83 million are restricted funds and \$87 million are unrestricted funds. The \$83 million in restricted funds supports a range of programs and initiatives, many of which are related to the systemwide and Presidential Initiatives. Among those receiving the largest portions of these funds are:

- grant programs to support groundbreaking research (\$18 million for Lab Research Grant Programs);
- the medical centers and medical schools core to our patient care and health research missions (\$10 million for UC Health);
- the academic program designed to immerse undergraduate students in Washington DC-based public service programs (\$8 million to the UC Washington Center);
- and an innovative program to shift UC's energy usage to more sustainable sources (\$7 million to the Wholesale Power Program).
- In some cases, these funds are transferred directly to campuses in the form of research grant funding or other program services by agreement (i.e., Wholesale Power, UC Health).

Of the \$87 million with more spending flexibility, as of July 1, 2016, \$49 million was already committed to academic programs, systemwide initiatives, and multi-year campus commitments that the Chancellors and I have agreed are high priorities.

The largest items in the \$49 million include:

- a sustained effort to develop, demonstrate, and export solutions — throughout California, the United States and the world — for food security, health, and sustainability (\$5.2 million for the Global Food Initiative);
- support for current law students and recent law-school grads to pursue public service internships and careers (\$4.5 million for the Public Service Law Fellowships);

- investments in UC's efforts to become carbon neutral and develop groundbreaking climate solutions (\$2.5 million for the Carbon Neutrality Initiative);
- support for the growth of UC's newest campus in Merced (\$4.6 million for UC Merced Wetlands);
- investment in a new medical school to increase the number of physicians and address underserved patient communities in California (\$2 million for UC Riverside Medical School);
- efforts to significantly bolster UC's readiness for increasingly sophisticated threats to its student, research, patient, and alumni data (\$7.2 million for cybersecurity).

That leaves \$38 million, which accounts for roughly 10 percent of UCOP's operating and administrative budget. Ten percent is a prudent and reasonable reserve amount for the University to be fully prepared for unexpected expenses, such as cybersecurity threat response, and emerging issues, such as support for undocumented students. That said, I believe it makes sense to develop a UCOP-specific reserve policy to more clearly articulate to our stakeholders our approach toward fiscal forethought and prudence. We will do so.

Third, the report questions whether the systemwide and Presidential Initiatives are of value and in alignment with UC's mission. **Systemwide and Presidential Initiatives are critical programs that reflect core values of The Regents and address some of the most pressing issues facing the State.** The recommendations suggest reducing or eliminating these programs, which would impede the ability of some of our most vulnerable students to succeed, undermine research into critical issues, and lessen UC's public service impact – thereby undermining all three of UC's core missions.

UC's initiatives advance several of the State's highest priorities, including providing resources and support for undocumented students, developing groundbreaking climate solutions and mitigating the University's carbon footprint, advancing health-related research and programs, and strengthening the State's relationship with Mexico.

The initiatives also address some of The Regents' most pressing priorities, including enhancing diversity of students, faculty, and staff, improving the transfer process for community college students, ensuring increasingly comprehensive outreach to high schools and community colleges throughout the State, and serving the Central Valley through support of UC Merced's ambitious campus expansion. The elimination of these programs would be contrary to UC's

longstanding roles as an engine of social mobility for students from a wide-range of backgrounds and circumstances and as a driver of innovative and research-based solutions to some of the State and nation's most challenging issues.

All of these initiatives have received substantial public attention and promotion. UCOP frequently confers with The Regents about the initiatives, updates them on these initiatives, and provides the public relevant information through public events, press releases, press interviews, websites, and social media channels. In addition, many initiatives – such as those pertaining to cyber security and preventing and responding to sexual violence and sexual harassment – are ongoing efforts and are included as part of the formal budget presentation to The Regents. We do agree, though, that there is always room to improve our communication and presentation of the initiatives, and we look forward to adopting many of the report's recommendations in this area.

Systemwide and Presidential Initiatives not only reflect UC's mission, but also substantially benefit the campuses and their students, faculty, and staff. A portion of funds for these initiatives and the majority of UCOP's budget comes from an assessment of the campuses. This structure is a result of the Funding Streams Initiative launched in fiscal year 2011-12, which shifted revenues directly to the campuses. It was designed to simplify University financial activity, improve transparency, and incentivize campuses to maximize revenue. The primary goal of Funding Streams was to establish an appropriate level of core funding for UCOP's central administration and governance activities while minimizing campus assessment funds; doing so maximizes funding for the University's fundamental teaching, research, and public service missions. UCOP has worked to limit the growth and volatility of the assessment, allowing for more predictable campus level budgeting and better long-term financial planning.

From fiscal year 2011-12 to fiscal year 2015-16 the assessment increased from \$278 million to \$304 million, a compound annual growth of only 2.3 percent. Over this same period, our systemwide revenue increased from \$24 billion to \$31 billion, a compound annual growth of 6.8 percent, and the number of students has grown from 237,057 in 2011-12 to 253,489 in 2015-16, an increase of nearly 7 percent. **Since I joined UC in 2013, the assessment share of total systemwide revenue has dropped from 1.08 percent to 0.98 percent.** Nowhere in the draft report is there mention of this critical context.

Fourth, the report suggests that UCOP has not adequately shared information about its budget and financial activities. **Through a variety of methods, UCOP has made wide-ranging and extensive information about its budget and financials publicly available.**

Since 2007, when UC adopted an entirely new funding methodology for the campuses and for UCOP, the UCOP budget has been presented annually to The Regents for approval. Historically, the UCOP budget is presented to The Regents at their May or July meetings. In addition to the Regents' Meeting itself, the Chair and Vice Chair of the Finance Committee receive a more detailed briefing about the UCOP budget, including information at the divisional and department level.

UC provides even greater financial detail publicly in its annual Campus Financial Schedules, which show revenue by fund source, expenditures by functional area, and expenditures by department. UCOP is included in this detailed presentation format. As your team was made aware, schedules dating back to 2004-05 are available at <http://ucop.edu/financial-accounting/financial-reports/campus-financial-schedules/index.html>. Finally, annual financial statements for the University of California, including UCOP, are prepared and audited on a consolidated basis by an outside auditor. The audited financial statements are included in the University's Annual Financial Reports and are available at <http://reportingtransparency.universityofcalifornia.edu/>.

Fifth, the draft report understates the extensive controls that have been instituted since I joined the Office of the President in 2013. Over the past several years, we have made many improvements to our budget and administrative processes – and will continue to further such progress. **Expenditures from the unrestricted or discretionary carry-forward funds must be approved through UCOP's formal decision-making process. The documents associated with that process outline the purpose, objective, and options for the expenditure and the vast majority must be reviewed and approved by me, personally.** In addition to expenditures from those funds, I have instituted a process that requires my explicit approval for use of outside consultants and contractors. While I am proud of the increasingly rigorous controls we have put into place at UCOP over the past few years, I agree that we can further enhance these processes and remain committed to doing so.

Finally, I have concerns that this draft report also understates how UCOP differs from every other university system office in the nation. **UCOP manages programs that serve the entire system, allowing campuses to capture the savings and efficiencies of centralized operations, while coordinating activities that allow them to operate as one university – all this, with its core operations and staff comprising just 1 percent of UC's overall budget.** By way of example, across 15 activity areas, ranging from the administration of systemwide retirement plans, to the centralized management of systemwide debt, to the administration of a systemwide financial aid, none of the

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other 10 largest system offices (as measured by total systemwide expenditures) provide more than four functions. UCOP, by contrast, provides all 15 critical systemwide services. These efforts have generated significant savings. For instance, through UC Health's Leveraging Scale for Value Program, the system has saved approximately \$520 million over the past two years.

As I have stated throughout this response, I believe a majority of your recommendations are reasonable and align with UCOP's existing practices, current plans, as well as its proactive efforts to continually improve. For many, we agree with the recommendation as written, such as exploring the development of a reserve policy with The Regents, working with them to incorporate your suggested additions to our annual budget presentation, and evaluating our employee reimbursement policies and appropriately revising them. For others, we agree with the spirit and intent of the recommendation, and will take a slightly varied approach to address the underlying concerns. Examples include limiting assessment growth in the place of reallocating savings to campuses or analyzing the impact of narrowing our salary ranges before committing to doing so.

As you can see, we have taken your recommendations seriously and are committed to their implementation. Our willingness to incorporate into our policies your evaluation and recommendations is reflected in our detailed response. UCOP will seize this opportunity to further enhance its value to students, campuses, Regents, the Legislature, and the citizens of California.

Yours very truly,



Janet Napolitano
President

Enclosures:

Attachment 1: CSA Recommendations to UCOP – Response
Attachment 2: CSA Report Assertions – Detailed Response