AUDIT AND ADVISORY SERVICES

Funds Functioning as Endowments Audit Project No. 11-571

June 29, 2011

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June 29, 2011

Scott Biddy
Vice Chancellor
University Relations

Vice Chancellor Biddy:

We have completed our audit of funds functioning as endowments (FFEs) as per our annual audit plan in accordance with The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* and the University of California Internal Audit Charter.

The audit objective was to evaluate the lifecycle of FFEs by reviewing the adequacy of governance practices and to evaluate controls related to creation, management and adherence to fund terms. The audit scope included FFEs that were new, augmented or where principal had been withdrawn between FY2007 and FY2011. Audit techniques included in-depth discussions with departmental personnel, questionnaires and detailed testing of selected FFE activity.

We observed that overall management of FFEs appears adequate to generally assure compliance with systemwide policies and prudent fiscal practices. In particular, we observed that the design of control activities governing the lifecycle of the FFE appears to provide reasonable assurance that creation of FFEs is in accordance with original fund sources. However, we observed certain opportunities for improvement. Withdrawals requiring presidential approvals had been completed without them. In addition, the campus has not developed a process for administering certain types of requests and has not documented campus procedures for allocating and reallocating gifts and bequests within their jurisdiction. Further, our review highlighted the need for the campus to revisit the FFE financial model for projects requiring short-term principal withdrawals. Lastly, in one case, principal from a true endowment was mistaken as an FFE and withdrawn in error. University Relations will review their process and develop campus procedures and guidelines for the administration of FFEs in accordance with the systemwide administrative guidelines and to strengthen their process overall by October 31, 2011.

During the course of our review, Audit and Advisory Services also identified other activity related to the Intercollegiate Athletics' Endowment Seating Program that is outside of the scope of this audit but has resulted in further discussions with management that may be reported separately, if consequential.

The aforementioned with management action plans are expounded upon in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to Gift Management and other departmental staff in the sample for their cooperative efforts throughout the audit process.

Please do not hesitate to call on Audit and Advisory Services if we can be of further assistance in this or other matters.

Respectfully reported,

Wanda Lynn Riley
Chief Audit Executive

cc: Vice Chancellor John Wilton
Executive Vice Chancellor and Provost George Breslauer
Executive Director Rosemary Kim
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University of California, Berkeley
Audit and Advisory Services
Funds Functioning as Endowments

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OVERVIEW

Executive Summary

We conducted a review of funds functioning as endowments (FFEs) as of FY2011. We observed that overall management of FFEs appears adequate to generally assure compliance with systemwide policies and prudent fiscal practices. In particular, we observed that the design of control activities governing the lifecycle of the FFE appears to provide reasonable assurance that creation of FFEs is in accordance with original fund sources. However, we observed certain opportunities for improvement. Withdrawals requiring presidential approvals had been completed without them. In addition, the campus has not developed a process for administering certain types of requests and has not documented campus procedures for allocating and reallocating gifts and bequests within their jurisdiction. Lastly, our review highlighted the need for the campus to revisit the FFE financial model for projects requiring short-term principal withdrawals. Management has provided responses including their commitment to understand and follow the systemwide guidelines, create and administer campus procedures, and determine whether the FFE funding model is appropriate for certain projects and ways to address those needs. In addition, they also commit to engaging stakeholders to strengthen controls that reside in their areas.

Source and Purpose of the Audit

Gift Management in University Relations is responsible for accepting private donations to the campus, establishing and managing funds and endowments, reporting to donors and organizations, and ensuring the long-term use of charitable gifts, including funds functioning as endowments (FFEs). The audit objective was to evaluate the lifecycle of FFEs by reviewing the adequacy of governance practices and to evaluate controls related to creation, management and adherence to fund terms. Audit techniques included in-depth discussions with departmental personnel, questionnaires, review of policies and procedures, review of FFE activity spreadsheets and detailed testing of selected FFE transaction activity (newly created, augmented, withdrawn) from FY2007 to FY2011.

Scope of the Audit

The audit scope was to evaluate controls related to prevention of five conditions:

1. The use of unallowable fund sources to fund FFEs;
2. Gift funds with incompatible terms and conditions being pooled together;
3. FFE activity not being approved at the appropriate levels;
4. Payouts and withdrawals not being used in accordance with the terms; and
5. Early withdrawal leading to unfulfilled long term goals including loss of value and earning potential.

The scope included FFE transaction activity from FY2007 to FY2011.

Background Information

Gift Management

Gift Management serves as the chief policy adviser to the campus fundraising community and administers campus, UC Berkeley Foundation (UCBF), Regents, and Office of the President policies. Gift Management also ensures that Berkeley's institutional and fiduciary responsibilities for managing private donations comply with donor intent, University policies, and applicable state and federal laws.

Campus Endowment

With funds invested prudently and generally in perpetuity, Berkeley's endowment provides a resilient, long-term financial resource. Through careful investment and new gifts, the growth of the endowment can help to protect Berkeley from fluctuations in the economy and changes in government funding. While there is no way to completely predict how market events will ultimately impact performance, the investment strategies for the campus endowment are highly diversified and oriented toward long-term growth. In addition, structured payout methodologies based on rolling averages of market values help insulate the endowment from market volatility.

Berkeley's endowment was estimated at $2.6 billion as of June 30, 2010, which reflects the combined value of two separate endowment pools, one managed for the UCBF by the Berkeley Endowment Management Company (BEMCO), valued at $895 million as of June 30, 2010, and the other managed by the UC Regents, valued at $1.7 billion as of June 30, 2010. This combined total reflects both true endowments (from which principal cannot be withdrawn) and FFEs.

In 2009, the UCBF created BEMCO, a subsidiary corporation to manage the investment of endowment gifts. Prior to that, the Foundation's endowment pool was managed by volunteer investors consisting of alumni and other professionals from the investment community.

Funds Functioning as Endowments

Designation of a gift or bequest as an FFE or quasi-endowment may be made by a donor or as an administrative decision if both the principal and payout are to be available for expenditure. Gift Management has administered the process under the expectation that minimum investment periods before withdrawals should be no sooner than two to three years for Foundation FFEs and five years for Regental FFEs. During that initial investment period, only the income (annual payout) from the investment is transferred to departments to spend. FFEs can be established primarily from revenue, current or plant funds, discretionary funds, and private gifts or bequests if restrictions are not stipulated by the donor. FFEs may be established for a wide variety of purposes, including capital projects, graduate fellowships, undergraduate scholarships, program support, and general operations.

If the beneficiary wishes to draw upon the corpus of an FFE, the Chancellor may delegate authority for such withdrawal up to a market value of $1,000,000. Authority for withdrawal from a fund valued up to $5,000,000 remains with the Chancellor. The Chancellor may approve withdrawals from an FFE with a market value over $5,000,000 when no more than five percent of the market value of a fund is to be withdrawn in a single year, over and above the annual payout. However, the President of the University must approve withdrawals from a fund with a market value over $5,000,000 when more than five percent of the market value of the fund is to be withdrawn in a single year.

For the purpose of our audit, we noted the following authoritative documents that govern the management of FFEs:

1) Administrative Guidelines for Allocation, Reallocation and Administration of Gifts and Bequests Received by the Regents and the Campus;
2) Development Policy and Administration Manual;
3) Accounting Manual E-525 Endowment and Similar Funds;
4) UC GEP Investment Policy Statement;
5) Administrative Guidelines for Campus Foundations;
6) Guidelines for Endowment Administration;
7) UC President's Delegation of Authority—Allocation and Reallocation of Gifts to Chancellors dated September 11, 2006;
8) Uniform Prudent Management of Institutional Funds Act; and
9) Uniform Prudent Investor Act.

Summary Conclusion

As the campus continues to identify ways to create and grow long-term reserves with more flexibility than true endowments but with the potential for sustainable growth, FFEs have been identified as a model that can achieve that goal. On campus, they have been created to fund a variety of projects such as scholarship programs, minor and major capital projects, staff salary funds, etc. Fund sources for FFEs include unit revenue, discretionary funds, or unrestricted gifts with terms that are generally designed to provide the flexibility of withdrawing from the principal while encouraging long-term growth.

We observed that, overall, FFEs appeared to be a model that allows the campus to have more funding options amid economic cut backs and uncertainty. Overall, administration of the FFE process and accountability over records appears adequate. However, our audit identified the following specific observations:

- Withdrawals which required presidential approvals according to systemwide guidelines had been completed without them.
- The campus has not yet developed a process for administration of certain withdrawal requests or documented campus procedures for allocating and reallocating gifts and bequests within their jurisdiction.
- The FFE model, as currently outlined, may not be the most appropriate financial model for projects requiring more liquidity and short-term access, such as, capital projects.
- Two true endowments were included in an FFE withdrawal request and a principal withdrawal of $15,000 occurred in one of the two.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Withdrawal Approval Authority

Observation

Opportunities exist to strengthen controls to ensure understanding of and compliance with *Systemwide Administrative Guidelines for Allocation, Reallocation and Administration of Gifts and Bequests Received by the Regents and the Campus (9/11/2006) (administrative guidelines),* by all who are involved in the gift management process, specifically with regard to approval requirements for withdrawals.

The administrative guidelines require that withdrawals from an FFE with a market value over $5 million and for which more than five percent of that value is being withdrawn in one year must be approved by the President. We understand that five percent of the market value in addition to the annual FFE payout amount was the systemwide benchmark established to ensure that a campus and/or endowment pool would not be financially overextended by one or a series of high value withdrawals over the course of any one year.

During our review of FFE withdrawals we noted that:

a) The Intercollegiate Athletics' Endowment Seating Program FFE W4000 capital project was established on October 1, 2009 and two withdrawals were made eight months afterward on June 15, 2010 for $3,609,224 and on June 24, 2010 for $1,400,000. These withdrawals represented 32% and 13%, respectively, of the market value of the FFE at the time and required presidential approval for each transaction, which was not obtained.

b) The Berkeley Art Museum/Pacific Film Archive Project Fund (W5770) capital project FFE was established on May 31, 2005. The initial investment was $10M. Three withdrawals occurred between March 2007 and November 2008 which were in the amounts of $2,453,403, $4,160,000, and $5,489,000 and approximately 25%, 40% and 99%, respectively, of the market value at those times but presidential approval was not obtained. The second withdrawal was for a reimbursement to a donor.

Management Response and Action Plan

Management concurs and will follow the guidelines going forward. We have a current request to withdraw more than five percent from an existing FFE fund, with a market value over $5M. We plan to submit a waiver memo (as per the *Administrative Guidelines for Allocation, Reallocation and Administration of Gifts and Bequests*) to the President requesting a one-time exception which would allow us to withdraw more than five percent. We plan to submit the waiver memo by July 1, 2011. A new withdrawal request that required the President's approval was submitted on June 10, 2011.

Campus FFE Policies and Procedures

The administrative guidelines state that "each Chancellor must establish written procedures and other allocation practices by December 31, 2006". We observed that the campus has not yet created this written procedure and that the absence of clear and documented internal procedures for the FFE management process has caused confusion about roles, responsibilities and appropriate procedures. This situation further resulted in instances of noncompliance with the guidelines as observed during our detailed testing. An internal procedure document would likely help to ensure that FFEs are handled in accordance with the objectives of the guidelines, which should be consistent, documented and communicated to FFE applicants.

Management Response and Action Plan

At the time that the Administrative Guidelines for Allocation, Reallocation and Administration of Gifts and Bequests was implemented on September 11, 2006, University Relations, after consultation with Institutional Advancement at the Office of the President (OP), chose to adopt the OP Guidelines as the campus guidelines. Given new fund scenarios and campus needs, University Relations will develop campus guidelines for the administration of the systemwide administrative guidelines. During this process, University Relations will also review and update any existing procedures as they relate to the allocation, reallocation, and administration of gifts and bequests. The review and development of campus procedures and guidelines will be completed by October 31, 2011.

FFE Funding Model for Certain Projects and Systemwide Guidelines

As noted in the first two observations, the systemwide guidelines and policies regarding FFEs and the absence of a campus policy and procedure do not currently appear sufficient to address the unique financial needs of capital and certain other projects. The short-term withdrawal schedule and size of withdrawals required in relation to market value appear to contradict the long-term objective of FFEs as stated in the systemwide guidelines.

Although the administrative guidelines encourage "maximum flexibility", the FFE model assumes that funds can remain invested for the long term through periods of economic growth and contraction. In general, Gift Management has administered the process under the expectation that minimum investment periods before withdrawals should be no sooner than two to three years for Foundation FFEs and five years for Regental FFEs. However, we observed that withdrawals sooner than the minimum investment period and at greater than the policy limit of five percent for certain projects may be anticipated by the department in advance.

A clear schedule of anticipated withdrawals for FFEs funding capital and certain other projects with annual updates would provide Gift Management and the attendant financial offices a framework for implementing the FFE model.

Management Response and Action Plan

Management concurs that the systemwide guidelines and policies regarding FFEs and the absence of a campus policy and procedure do not appear sufficient to address the uniqueness of the FFE funding needs for capital and certain other projects. University Relations will initiate a discussion meeting with the campus Budget and Planning Office to review the FFE funding model and determine next steps. The outcome will be to ensure that campus-financing needs are met while maintaining compliance with the systemwide administrative guidelines. In addition, we will create new campus guidelines and procedures for the administration of FFEs by October 31, 2011.

Withdrawal from the Principal of a True Endowment

We observed opportunities to improve the process of distinguishing FFEs from true endowments and ensuring that withdrawal requests for true endowments are detected and rejected.

In one FFE withdrawal request in our sample, there were two true endowments initially included in a cumulative request from the department to withdraw from 12 FFE's on May 25, 2010. Though one of the true endowments was detected before the withdrawal from principal was made, the second was not and $15,000 was withdrawn.

Prior to issuance of this report, Audit and Advisory Services confirmed that the $15,000 had been deposited back into the true endowment on June 6, 2011.

Management Response and Action Plan

Management concurs with the finding above and will reinforce the following process immediately. Each request will be reviewed to confirm that withdrawals are from FFEs; that the requestor is authorized to make the request; and that the fund terms allow for invasion of principal. The new process of confirming withdrawal requests will be implemented by October 31, 2011.