



AUDIT AND ADVISORY SERVICES
Tel: (510) 642-8292

611 UNIVERSITY HALL #1170
BERKELEY, CALIFORNIA 94720-1170

December 20, 2018

Stephen Sutton
Vice Chancellor
Student Affairs

Vice Chancellor Sutton:

We have completed our audit of Bowles Hall as per our annual service 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.

Our observations with management action plans are presented in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to the staff of Student Affairs, Real Estate, and Facilities Services 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,

Jaime Jue
Interim Director

cc: Executive Vice Chancellor and Provost Paul Alivisatos
Vice Chancellor Finance and Chief Financial Officer Rosemarie Rae
Vice Chancellor Cathy Koshland
Vice Chancellor Marc Fisher
Interim Chief Operating Officer Tom Lowry
Associate Chancellor Khira Griscavage
Assistant Vice Chancellor and Controller Delphine Regalia
Senior Vice President and Chief Compliance and Audit Officer Alexander Bustamante



AUDIT AND ADVISORY SERVICES

Bowles Hall
Audit
Project No. 18-708
December 20, 2018

Prepared by:

Reviewed and Approved by:

Dorothy Lipari
Auditor-in-Charge

Jaime Jue
Interim Director

**University of California, Berkeley
Audit and Advisory Services
Bowles Hall Audit**

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OVERVIEW

Executive Summary

The purpose of the audit was to assess the adequacy and effectiveness of risk management, control, and governance processes in providing reasonable assurance that management of the contract with the Bowles Hall Foundation (the Foundation) is compliant with the terms and conditions, meets student services objectives, safeguards the campus assets, and achieves financial goals.

Based on the results of the audit work performed, we observed the following opportunities to strengthen processes and controls to ensure long-term campus objectives are met through management oversight, compliance assurance, and emergency preparedness.

Stable and Consistent Long-Term Management Oversight

There is opportunity for the campus to strengthen its oversight of the Bowles Hall arrangement by creating an official charge from the campus to its three representatives serving on the Foundation's board as to their fiduciary duty on behalf of the campus. These positions should be apprised of the key risks associated with the arrangement and should monitor the risks over time. Future changes to the risk profile should be documented and risk issues reported back to campus leadership in the event escalation or corrective action needs to be pursued with the Foundation.

There is also opportunity for the campus to strengthen oversight of its activities by identifying key roles and responsibilities related to contractual obligations in the ground lease and cooperation agreement and assigning them to campus management. Key roles and responsibilities should be formally documented and communicated to successive campus leaders to help ensure that the long-term goals of effective coordination and oversight are achieved.

Compliance with Campus Rules and Applicable Regulations

The Foundation is required to manage and operate the premises in compliance with "Campus Rules and Applicable Law".

Given the complexity of laws, regulations, and university and campus policies and rules that apply to the arrangement, it would be beneficial for the campus to identify, prioritize, and communicate key requirements and associated campus contacts to the Foundation. This would assist them in understanding and adhering to the requirements. While an annual certification process by which the Foundation certifies compliance with the articulated requirements does not currently exist, it would provide additional assurance to the campus.

Emergency Preparedness and Business Continuity

Bowles Hall does not have a formal emergency operational plan or a business continuity plan similar in rigor and detail to those required by campus units. The campus should consider the extent to which Bowles Hall should be included in the scope of the campus's emergency operations, planning and testing. In the event that Bowles Hall is considered autonomous in the area of

emergency preparedness and business continuity, the campus may wish to consider a mutual aid agreement or assist the Foundation to establish such an agreement with another party.

Earthquake Insurance

Under the lease agreement, the Foundation is required to purchase “earthquake insurance, if available from reputable insurers at a reasonable cost”. The Foundation represented it does not carry earthquake insurance for Bowles Hall because they were not able to find coverage at a cost that would not have significantly increased their operating expenses. Complicating the situation, the cooperation agreement indicates that the Foundation shall not charge fees significantly more than comparable campus-operated housing, which limits its ability to pass along the cost of earthquake insurance coverage to residents.

Given the significant risk of a major earthquake in the next 40 years, the campus should assess the situation and explore a course of action that considers various alternatives, including assisting in the acquisition of the coverage through its presence and buying power in the marketplace or extending its self-insurance program to include Bowles Hall.

Source and Purpose of the Audit

The purpose of the audit was to assess the adequacy and effectiveness of risk management, control, and governance processes in providing reasonable assurance that management of the contract with the Bowles Hall Foundation is compliant with the terms and conditions, meets student services objectives, safeguards the campus assets, and achieves financial goals.

Scope of the Audit

The audit scope included the agreements between the university and the Bowles Hall Foundation, including the Ground Lease, the Cooperation Agreement, and the Memorandum of Understanding – Use of Net Available Cash Flow. Key components of the campus’s obligations contained in these agreements were included in the review.

Under the ground lease, whereby the University of California leases the land and building to the Bowles Hall Foundation for 40 years at no cost, and the Foundation agrees to maintain the property and to operate a residential student housing facility, complying with all “campus rules” and applicable regulations. At the end of the lease, the property reverts to the University of California. Annual excess net available cash flows as defined in the Memorandum of Understanding, are distributed evenly between the Bowles Hall Foundation and the University of California.

Also included in the scope were key components of the lessee’s obligations as identified from the campus’s perspective, however, this was not an audit of Bowles Hall or the Bowles Hall Foundation. The period reviewed was July 1, 2016 to June 30, 2017, the first year of operation.

Background Information

Bowles Hall opened in 1929 and is believed to be the nation’s first residential college. It was added to the National Register of Historic Places in 1989. From its beginning, it operated as a residential college for male students, then in 1970 it transitioned to a conventional dormitory for men. In 2005, former “Bowlesmen” established the Bowles Hall Alumni Association and made a pact to reestablish the residential college model. In 2016, Bowles Hall reopened as a full residential hall, housing approximately 200 men and women undergraduate students. It has a self-governing structure and maintains integrated academic guidance, counseling, and an active social program.

The Bowles Hall Foundation is a non-profit organization dedicated to preserving the history, tradition, fellowship, and support of Bowles Hall on the University of California, Berkeley campus. It is responsible for all efforts that support Bowles Hall, including its student residents and its alumni. Its board members consist of members of the Bowles Hall Alumni Association, campus academics and administrators, and other external leaders from the academic and business communities. Bowles Hall maintains a college dean and college principal on site, with other staff and undergraduate fellows who administer the academic and residential programs.

The Bowles Hall Foundation working with EDR Development LLC (the developer) was responsible for renovating Bowles Hall and financing the renovation through \$40 million in bonds. The trustee was The Bank of New York Mellon Trust Company, N.A. The bonds were issued by the California Municipal Finance Authority and underwritten by Raymond James. The bonds are payable over the 40-year life of the lease and are serviced from student rents. The Bowles Hall

Foundation is also responsible for operating the facility in cooperation with its management company, EDR Management, Inc.

Summary Conclusion

Based on the results of the audit work performed, we observed the following opportunities to strengthen processes and controls to ensure long-term campus objectives are met through management oversight, compliance assurance, and emergency preparedness.

Stable and Consistent Long-Term Management Oversight

There is opportunity for the campus to strengthen its oversight of the Bowles Hall arrangement by creating an official charge from the campus to its three representatives serving on the Foundation's board as to their fiduciary duty on behalf of the campus. These positions should be apprised of the key risks associated with the arrangement and should monitor the risks over time. Future changes to the risk profile should be documented and risk issues reported back to campus leadership in the event escalation or corrective action needs to be pursued with the Foundation.

There is also opportunity for the campus to strengthen oversight of its activities by identifying key roles and responsibilities related to contractual obligations in the ground lease and cooperation agreement, and assigning them to campus management. Key roles and responsibilities should be formally documented and communicated to successive campus leaders to help ensure that the long-term goals of effective coordination and oversight are achieved.

Compliance with Campus Rules and Applicable Regulations.

The Foundation is required to manage and operate the premises in compliance with "Campus Rules and Applicable Law".

Given the complexity of laws, regulations, and university and campus policies and rules that apply to the arrangement, it would be beneficial for the campus to identify, prioritize, and communicate key requirements and associated campus contacts to the Foundation. This would assist them in understanding and adhering to the requirements. While an annual certification process by which Bowles Hall certifies compliance with the articulated requirements does not currently exist, it would provide additional assurance to the campus.

Emergency Preparedness and Business Continuity

Bowles Hall does not have a formal emergency operational plan or a business continuity plan similar in rigor and detail to those required by campus units. The campus should consider the extent to which Bowles Hall should be included in the scope of the campus's emergency operations, planning and testing. In the event that Bowles Hall is considered autonomous in the area of emergency preparedness and business continuity, the campus may wish to consider a mutual aid agreement or assist the Foundation to establish such an agreement with another party.

Earthquake Insurance

Under the lease agreement, the Foundation is required to purchase “earthquake insurance, if available from reputable insurers at a reasonable cost”. The Bowles Hall Foundation represented it does not carry earthquake insurance because they were not able to find coverage at a cost that would not have significantly increased their operating expenses. Complicating the situation, the cooperation agreement indicates that the Foundation shall not charge fees significantly more than comparable campus-operated housing, which limits the ability of the Foundation to pass along the cost of earthquake insurance coverage to residents.

Given the significant risk of a major earthquake in the next 40 years, the campus should assess the situation and explore a course of action that considers various alternatives including assisting in the acquisition of the coverage through its presence and buying power in the marketplace or extending its self-insurance program to include Bowles Hall.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Stable and Consistent Long-Term Management Oversight

The Bowles Hall arrangement is unique in that the lease spans a 40-year time period and, because of its length, it will be overseen by successive campus leadership. Structured oversight by the campus is needed to promote the long-term success of the arrangement, both financially and programmatically, and to facilitate the inevitable changes in management over its life. Oversight, including a strong system of processes and internal controls, will help ensure that the campus's long-term objectives for student housing in a residential college model are met, even as campus management turns over. We found that such structures are not currently in place and that a loss of institutional knowledge about the history, purpose, and objectives of this arrangement may eventually be lost.

The campus's most direct permanent mechanism of oversight are its three positions on the Foundation's board. We found that these positions do not have an official charge from the campus as to their fiduciary duty on behalf of the campus. As the individuals filling those seats turn over, an official charge would help the new board members to understand their duty insofar as consistently representing the interests of various campus stakeholders. Key stakeholders include the Academic Senate and the Executive Vice Chancellor and Provost, for the academic advising component; the Vice Chancellor for Student Affairs, for the student housing and student conduct component; the Vice Chancellor of Administration, for stewardship of the facility that will return to campus service at the end of the lease; and the Vice Chancellor of Finance, for monitoring the overall financial health of operations and the potential risk of financial underperformance or default on debt service. These positions should be apprised of the key risks associated with the arrangement and should monitor risks over time. Future changes to the risk profile should be documented and risk issues reported back to campus leadership in the event escalation or corrective action needs to be pursued with the Foundation.

To assure that stakeholders are kept aware of items that may affect the ability to achieve campus objectives in their areas, a reporting structure, such as an annual report from the campus board members, should be established that can provide periodic reporting on the programmatic, operational, financial, and compliance status of Bowles Hall. The campus could establish standards for this reporting, which would assist subsequent campus board members with fulfilling their duty.

Additionally, within campus management, key contacts and responsible parties should be identified related to contractual obligations in the ground lease and cooperation agreement so that roles and responsibilities are clear. The areas of contractual obligations include facility-related services provided to Bowles Hall, marketing to prospective residents, periodic review of financial disclosures, and coordination with student life and environment, health, and safety matters. Formally documenting and communicating roles and responsibilities will help to ensure, with successive campus leaders, that the long-term goals of effective coordination and oversight are achieved.

Management Response and Action Plan

The Office of the Vice Chancellor for Student Affairs (VCSA), in consultation with the VC for Finance, will work with the Bowles Hall Foundation to establish official charge letters with terms of service for all UC Berkeley faculty and staff that serve on the Bowles Hall Foundation Board of Directors. The Office of the VCSA, in consultation with the VC for Finance, will also implement an “annual report” requirement which will enable the campus administration to be briefed on the programmatic, operational, financial, and compliance status of the residential college elements of Bowles Hall. Contractual obligations between the Bowles Hall Foundation and campus service providers will be reviewed and evaluated on an annual basis to ensure clarity and consistency. In addition, where not already present, formal roles and responsibilities will be assigned to campus personnel to ensure ongoing accountability and oversight by relevant campus units.

Estimated Completion Date: October 1, 2019

Compliance with Campus Rules and Applicable Regulations

The Cooperation Agreement (Article 2.4.4.1) recognizes that the Berkeley campus maintains campus-wide policies and procedures and defines these as “campus rules”. It states that “Lessee shall manage and operate the Premises in compliance with Campus Rules and Applicable Law”.

Given the complexity of external laws and regulations, as well as university and campus policies and rules that may apply to the Bowles Hall arrangement, we believe it would be helpful for the campus to identify, prioritize, and communicate to the Bowles Hall Foundation those key rules and requirements that it should be aware of in its operation of Bowles Hall and the residential college program. Our understanding from interviewing the current college dean is that the campus has not articulated its specific expectations and that rather the dean is working from a general understanding based upon his other role as a faculty member. In addition, as campus rules and regulations change over time, a periodic update of these requirements is warranted. Campus training and informational resources could be made available to Bowles Hall staff to help them understand and adhere to the requirements.

In the absence of communication, there is risk that the college dean or other responsible parties at the Hall do not recognize or proactively address situations that are not compliant with campus rules and requirements, including potential mandatory reporting to designated campus units in the case of sensitive or criminal activity.

We further observed that an annual certification process by which the college dean, or other designated representatives of the Foundation, certify compliance with the articulated rules and requirements would be helpful to provide assurance to campus management and would create an opportunity for mutual discussion of potential issues. A list of campus contacts for questions or advice in specific compliance or regulatory areas would also be helpful for Bowles Hall staff.

Management Response and Action Plan

A checklist of items needed to manage a modern and developmentally focused residence hall was provided to the Bowles administration prior to the opening of the Residential College. The Office of the VCSA, in consultation with the VC for Finance, will review and periodically update this list of specific rules and requirements to ensure annual compliance by the Bowles Hall Foundation with key campus rules, policies, and procedures as well as applicable laws and external regulations.

Estimated Completion Date: October 1, 2019

Emergency Preparedness and Business Continuity

During and immediately subsequent to an emergency situation, the safety, provision, and wellbeing of the students, faculty and staff is of utmost importance. We understand that Bowles Hall does not have a formal emergency operational plan or a business continuity plan similar in rigor and detail to those required by campus units to address immediate life safety issues, emergency operations, and eventual full resumption of business operations in the event of an emergency or business disruption.

Given its nature as a residential facility housing Berkeley students, campus management should consider the extent to which campus emergency management and business continuity practices should be required of Bowles Hall under the compliance with the “campus rules” requirement of the agreement. Also, the extent to which the campus includes Bowles Hall in the scope of its own emergency operations planning and testing, similar to other campus-operated housing facilities (and when Bowles Hall was a part of that portfolio) should also be considered.

In the event that the Foundation prefers to assert autonomy in the area of emergency preparedness and business continuity, the campus may wish to explore a mutual aid agreement or assist the Foundation to establish such an agreement with another party. Although the Foundation is a separate 501(c)3 organization and will operate Bowles Hall independently for the next 40 years, given its exclusive mission to serve only Berkeley students, and the campus’s residual interest in the facility after the lease ends, it may well be in the long-term interest of the campus to assist the Foundation to minimize, to the extent practical, any operational disruption in the event of an emergency.

Management Response and Action Plan

The Office of the VCSA, in consultation with the VC for Administration and UCPD, will work with the Bowles Hall Foundation to develop a specific emergency response plan for Bowles Hall. This will include a requirement by Bowles Hall to establish a formal emergency operational plan and a business continuity plan that will be submitted to the campus for review.

Estimated Completion Date: October 1, 2019

Earthquake Insurance

Given the location of Bowles Hall directly on the Hayward earthquake fault, the risk of significant structural damage to the facility or subsequent business interruption (i.e., it will be inoperable to house students) in the event of a major earthquake is of serious concern. Additionally, if Bowles Hall were inoperable, the revenue stream associated with the financing of seismic retrofit and renovation would be disrupted, raising the risk of potential default by the Foundation on debt service requirements.

The Lease Agreement (Article 23) requires that the Bowles Hall Foundation purchase “earthquake insurance, if available from reputable insurers at a reasonable cost”. However, the reasonable cost of earthquake insurance is not defined in the ground lease or any agreement for the arrangement and is therefore subject to interpretation. When interviewed, the Bowles Hall Foundation represented it does not carry earthquake insurance as part of its physical liability coverage because they were not able to find coverage at a cost that would not significantly have increased their operating expenses. Complicating this situation, the cooperation agreement states that the Foundation shall not charge fees significantly more than comparable campus-operated housing, which limits the ability of Bowles Hall to pass along the cost of earthquake insurance coverage to residents.

Given the significant risk of a major earthquake in the next 40 years, the campus may want to assess the situation and explore a course of action that considers various alternatives, including the following:

- Allow the Foundation to continue without earthquake insurance. Should a major earthquake occur, this acceptance of risk may result in major disruption to housing and food services for students, an inability for the Foundation to continue its debt service, and may leave the facility in permanent disrepair.
- Assist the Foundation in obtaining earthquake insurance, utilizing the university’s presence and buying power in the marketplace.
- Explore whether the university’s self-insurance earthquake program could be extended to Bowles Hall for the duration of the agreement.

Management Response and Action Plan

The Office of the VCSA, in consultation with the VC for Finance, will work with the Bowles Hall Foundation to obtain earthquake insurance and/or explore whether the university’s self-insurance earthquake program could be extended to Bowles Hall for the duration of the agreement. If neither of these options are feasible, the lease agreement clause requiring earthquake insurance will be enforced.

Estimated Completion Date: October 1, 2019