AUDIT AND ADVISORY SERVICES

Third-Party Relationships – Revenue Agreements Audit
Project No. 12-595

May 15, 2013

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UNIVERSITY OF CALIFORNIA, BERKELEY

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May 15, 2013

John Wilton
Vice Chancellor
Finance and Administration

Vice Chancellor Wilton:

We have completed our audit of Third-Party Relationships – Revenue Agreements 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.

Our observations with management action plans are expounded upon in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to the Business Contracts Office staff and selected campus units 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: Associate Vice Chancellor Ron Coley
Associate Vice Chancellor and Chief Financial Officer Erin Gore
Director Maria Rubinshteyn
Senior Vice President Sheryl Vacca
Associate Chancellor Linda Morris Williams
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University of California, Berkeley
Audit and Advisory Services
Third-Party Relationships – Revenue Agreements

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OVERVIEW

Executive Summary

The purpose of this audit was to evaluate the design and operating effectiveness of programs and controls related to revenue-generating agreements with third parties to assure:

- Contracted services are provided in accordance with the terms and conditions of the agreement.
- Remuneration is calculated accurately, collected timely, and recorded appropriately in the general ledger.
- Unrelated business income activities are identified and reported.
- Goods or services sold to outside consumers are unique.
- Sales are not in competition with commercial sources.
- Established charges recover full University costs.
- Agreements are evaluated to confirm excess capacity and expertise to fulfill agreement terms without compromising other University objectives.
- Agreements are vetted and executed in a manner compliant with University policies.

We selected a sample of six contracts in five units, based upon the nature and size of the contract, the counterparty, and management input.

Based upon our audit procedures, we observed that for the departments and agreements we sampled:

- Contracted services appeared to be provided in accordance with the terms and conditions of the agreement.
- Remuneration was calculated accurately and collected timely.
- Goods or services sold to outside consumers were unique and not in competition with commercial sources.
- Departments evaluated agreements to confirm their capacity and expertise to fulfill them.
- Agreements were vetted and executed in a manner compliant with University policies.

In addition, we had four individual observations that we discuss in detail:

First, University policy generally requires that the campus recover at least direct and related indirect costs when providing services to third parties. We observed that four out of five units in our sample generally employed reasonable methods to price services to recover direct costs. The fifth unit, which was a recharge unit, did not appear to recover additional direct costs related to the provision of the services that were not anticipated and included in the contracted rate. Because we noted that our sampled units used different methodologies to estimate indirect costs, we inquired with the individual departments as to the differing indirect cost estimation methods and learned that, in the absence of campus guidance on principles to estimate indirect costs for external revenue arrangements, they employed various methods that were unique to their department. We observed a need for the campus to provide guidelines on pricing services to consistently ensure that direct and indirect relevant costs are recovered and that departments and units do not enter into external revenue agreements where the contracted pricing arrangements result in a net negative financial impact on the campus.

Second, four of the five (80%) departments in our testing did not create, record and monitor receivables in the campus general ledger. Instead, they created invoices using manual systems. Although no invoice is recorded in the general ledger, revenue is recorded when the campus receives and records the customer payment. We believe financial risk related to receivables could be reduced by requiring units and departments to record their receivables in the general ledger at the time they are issued to the customer, allowing for better monitoring of aging and doubtful accounts.

Third, department heads have the primary compliance responsibility to notify campus General Accounting about activities that may be subject to unrelated business income tax (UBIT). Although we did not identify activities in our sampled agreements that were potentially subject to UBIT and not appropriately reported, we observed an opportunity to reduce compliance risk and improve business processes if the Business Contracts Office (BCO) were to include in their contract vetting process a consideration of the types of revenue activity that are in proposed agreements that may potentially be subject to UBIT, advise departments to complete the UBIT evaluation form and notify General Accounting to expect a completed form.

Lastly, revenue agreements with external parties require concurrent approval by the individual unit as well as a central campus office. Depending on the terms of the agreement and the services the campus expects to provide, approval could come from one of three units: BCO, the Sponsored Projects Office (SPO), or the Industry Alliances Office (IAO). We observed an opportunity to further enhance escalation procedures whereby complex, higher profile contracts are jointly discussed between BCO, SPO and/or IAO and a contract vetting approach is developed and agreed to early in the opportunity pursuit, reducing the likelihood of delays in approvals or questions about the appropriateness of the unit providing approvals after the fact.

Source and Purpose of the Audit

The purpose of this audit was to evaluate the design and operating effectiveness of programs and controls related to revenue-generating agreements with third parties to assure:

- Contracted services are provided in accordance with the terms and conditions of the agreement.
- Remuneration is calculated accurately, collected timely, and recorded appropriately in the general ledger.
- Unrelated business income activities are identified and reported.
- Goods or services sold to outside consumers are unique.
- Sales are not in competition with commercial sources.
- Established charges recover full University costs.
- Agreements are evaluated to confirm excess capacity and expertise to fulfill agreement terms without compromising other University objectives.
- Agreements are vetted and executed in a manner compliant with University policies.

Scope of the Audit

The scope of our audit included consideration of revenue-generating arrangements with external parties. We excluded from our scope sponsored research contracts and grants as we have conducted a separate audit of program income related to contracts and grants. We also excluded industry or corporate sponsored research since they are core to the fundamental mission of the University.

We focused the scope of the audit on how the individual unit or department managed the lifecycle of the contract after approval. We conducted a separate audit of BCO and the approval stage of the contract in the prior fiscal year.

Procedures Performed

As our audit focused on potential revenue-generating arrangements that excluded research sponsored by governments, industries, or corporations, we noted that non-research types of agreements are reviewed and approved by BCO on campus. We conducted preliminary interviews with BCO management as well as analysis of their Business Contract Management System (BCMS), which is the campus system of record for business contracts.

We reviewed summary attributes for the entire population of revenue agreements in BCMS for the period July 1, 2010 through December 31, 2011 and considered the risks associated with individual units, types of contracts, sizes of contracts (in dollars), and counterparties. Based on our analysis we identified five units who had significant numbers of revenue agreements reviewed and approved in BCMS:

- Haas School of Business – Center for Executive Education
- Lawrence Hall of Science
- School of Public Health
- Engineering Research Support Organization (ERSO)
- Research Enterprise Services (RES)

We selected a sample of six contracts for these five units, including amendments, based upon the nature and size of the contract, the counterparty, and management input. As ERSO and RES are administrative support units, their selected contracts related to two organized research units they support, the Pacific Earthquake Engineering Research Center and the Helen Wills Neuroscience Institute, respectively. We worked directly with department management to obtain an understanding of their contract management procedures related to our sampled contracts.

Background Information

Opportunities routinely arise for the campus to enter into revenue-generating arrangements with external third parties for services that may or may not be directly related to the University's joint mission of teaching, research, and public service. If the generated income is from a business activity unrelated to its regular activity, it may be subject to federal UBIT.

Several University and campus policies cover the vetting and pricing of such revenue-generating arrangements, including but not limited to:

- University of California, University Regulations Revised No. 4, Special Services to Individuals and Organizations. June 23, 1958.
- University of California, Academic Personnel Manual (APM), General University Policy Regarding Academic Appointees, Special Services to Individuals and Organizations. APM-020. June 23, 1958.
- University of California, Business and Finance Bulletin (BFB) A-47, University Direct Costing Procedures. September 1, 2008.
- University of California, BFB A-56, Academic Support Unit Costing and Billing Guidelines. September 30, 2008.
- University of California, BFB A-59, Costing and Working Capital for Auxiliary and Service Enterprises. October 13, 2008.
- University of California, BFB A-61, Policy on Unrelated Income and Expenses. January 17, 2012.
- University of California, Berkeley, Administrative Full Costing Policy. July 17, 2009.

We discuss these policies as they relate to the results of our audit procedures in our individual observations, which follow.

Summary Conclusion

Based upon our audit procedures, we observed that for the departments and agreements we sampled:

- Contracted services appeared to be provided in accordance with the terms and conditions of the agreement.
- Remuneration was calculated accurately and collected timely.
- Goods or services sold to outside consumers were unique and not in competition with commercial sources.
- Departments evaluated agreements to confirm their capacity and expertise to fulfill them.
- Agreements were vetted and executed in a manner compliant with University policies.

In addition, we noted that:

- University policy generally requires that the campus recover at least direct and related indirect costs when providing services to third parties. Based upon our testing procedures, we observed that four out of five units in our sample generally employed reasonable methods to price services to recover direct costs. The fifth unit, which was a recharge unit, did not appear to recover additional direct costs related to the provision of the services that were not anticipated and included in the contracted rate.

  Because we noted that our sampled units used different methodologies to estimate indirect costs, we inquired with the individual departments as to the differing indirect cost estimation methods we observed and learned that, in the absence of campus guidance on principles to estimate indirect costs for external revenue arrangements, they employed various methods that were unique to their department. The resulting indirect rate varied from 11 to almost 70 percent.

  We observe a need for the campus to provide guidelines on pricing services to consistently ensure that direct and indirect relevant costs are recovered and that departments and units do not enter into external revenue agreements where the contracted pricing arrangements result in a net negative financial impact on the campus.

- Four of the five (80%) departments in our testing did not create, record and monitor receivables in the campus general ledger. Instead, they created invoices using manual systems such as word processing software to create invoices and spreadsheets to track the aging and status of invoices issued. Although no invoice is recorded in the general ledger, revenue is recorded when the campus receives and records the customer payment.

  We believe financial and fraud risk related to receivables could be reduced by requiring units and departments to record their receivables in the general ledger at the time they are issued to the customer, allowing for better monitoring of aging and doubtful accounts.

- Department heads have the primary compliance responsibility to notify campus General Accounting about activities that may be subject to UBIT. Although we did not identify activities in our sampled agreements that were potentially subject to UBIT and not appropriately reported, we observed an opportunity to reduce compliance risk and improve business processes if BCO were to include in their contract vetting process a consideration of the types of revenue activity that are in proposed agreements that may potentially be subject to UBIT and, advise departments to complete the UBIT evaluation form and notify General Accounting to expect a completed form.

- Lastly, revenue agreements with external parties require concurrent approval by the individual unit as well as a central campus office. Depending on the terms of the agreement and the services the campus expects to provide, approval could come from one of three units: BCO, SPO, or IAO. We observed an opportunity to further enhance escalation procedures whereby complex, higher profile contracts are jointly discussed between BCO, SPO and/or IAO and a contract vetting approach is developed and agreed to early in the opportunity pursuit, reducing the likelihood of delays in approvals or questions about the appropriateness of the unit providing approvals after the fact.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Pricing External Contracts to Fully Recover Direct and Indirect Costs

Observation

Proper pricing of goods or services provided under a contract helps to ensure that, at a minimum, direct and indirect costs associated with work performed are recovered. It also reduces the risk that the arrangement will result in financial losses or deficits that must be covered from other organizational resources and reduce the potential appearance of cross-subsidization of non-core activity from core funds.

University policy requires pricing services provided to third parties meet minimum standards of cost recovery depending on the type of service provided. For example:

- Services involving the use of University facilities that lead to the extension of knowledge or to increased effectiveness in teaching through tests and investigations should be priced to be "sufficient to cover all expenses, both direct and indirect."[1]
- Sales of services provided by academic department support units to outside consumers as a part of the total operating program of an individual activity shall be priced to "recover University costs, both direct and indirect. Indirect costs shall include appropriate amounts for campus overhead costs. Guidelines for determination of such amounts to be recovered shall be provided by the local campus Budget office."[2]
- Sales of services provided by auxiliary and business enterprises "shall be charged for all direct costs involved in producing their goods and services. These costs include salaries and benefits, supplies and expenses, and equipment depreciation.... Also, all auxiliary enterprises shall be charged for all indirect costs that are judged to benefit the activities."[3]

To generalize the above policies, we note that University policy requires that the campus recover at least direct and related indirect costs when providing services to third parties.

We observed that four out of five units in our sample generally employed reasonable methods to price services to recover direct costs. The fifth unit, which was a recharge unit, did not appear to recover additional direct costs related to the provision of the services that were not anticipated and included in the contracted rate.

Because we noted that our sampled units used different methodologies to estimate indirect costs, we inquired as to how they identified, estimated, and recovered indirect costs relevant to the goods or services they were providing. These departments noted that the campus has not yet established and published guidance on how to identify and estimate indirect costs as contemplated by University and campus full costing policies. As a result, each developed and implemented their

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[1] University of California, APM 020, University Regulations Revised No. 4, "Special Services to Individuals and Organizations."

[2] University of California, BFB A-56, Academic Support Unit Costing and Billing, Section IV.H.

[3] University of California, BFB A-59, Costing and Working Capital for Auxiliary and Service Enterprises, Section IV.

own methodology. Typically, we saw their contracts specify an *ad valorem* rate applied to the dollar value of the contract, similar to a facilities and administration cost recovery rate with sponsored contracts and grants. The *ad valorem* rates used by units in our sample in many cases reflected rates used for sponsored projects, even though the campus is not required to use these rates for non-sponsored projects. However, one unit specified a fixed fee per unit of service for indirect costs in lieu of an *ad valorem* rate.

In practice, we observed one unit using an indirect cost rate of 11.5%, which recovers the 7% current campus assessment and 4% school assessment on external income. In this situation, the unit would therefore appear not to have the ability to recover other indirect costs associated with this project. The unit stated that they would have liked to negotiate a higher rate but that the counterparty was not willing to pay more than 11.5%.

On the other hand, we observed another unit using an indirect cost rate of almost 70%, which included a "commercial" rate of 53.5%, an "administration fee" of 7%, and "industry fee" of 9%. We note that the commercial rate used is identical to the negotiated rates for on-campus federally sponsored research, which itself is based on an indirect cost pool which includes buildings, equipment, operations and maintenance, interest, libraries, student services, general and departmental administration, etc. that may not be relevant to the provisioning of the contracted service.

We recognize that the campus does not generally conduct activity, process, or job-based full costing and that implementation of such measures for incremental amounts of external revenue may not be justified. However, as the campus seeks to enhance new and existing sources of external revenue in the absence of these measures, estimation methods must be employed. As a result, we observed a need for the campus to develop and communicate guidelines on pricing goods and services in third-party revenue agreements so that departments and units do not enter into agreements that result in a financial loss or deficit. BFB A-56 does state that for external revenue agreements "Indirect costs shall include appropriate amounts for campus overhead costs." and "Guidelines for determination of such amounts to be recovered shall be provided by the local campus Budget Office."

Management Response and Action Plan

The campus under the direction of VCAF is establishing within the Operational Excellence Program Office a "Revenue Generating Initiative". This will provide a formal review for entities looking to engage in entrepreneurial activities to generate revenue to support core mission items. This will relieve pressure from the disinvestment by the state and lessen pressure on tuition.

This office is constructing the support structure now. We believe this will provide a cross campus view of the benefits of the additional revenue as well as a view of the marginal costs of these activities or overhead. The campus looks forward to working with [Audit and Advisory Services] on this approach. The revenue generating initiative was officially launched in March 2013 and guidelines related to pricing, relative to indirect cost recovery, will be developed and communicated to campus by January 1, 2014.

Recording and Managing Receivables in the General Ledger

Observation

Generally Accepted Accounting Principles (GAAP) related to revenue recognition require recording revenue when it is realizable and earned, such as when services are rendered or goods delivered. If cash is not received in payment at the time the revenue is realized and earned, then a receivable is established in the general ledger.

The management benefits of recording receivables include the ability to: (1) track amounts due to the University at any given point in time, (2) calculate receivables aging to monitor how much credit has been extended and the associated credit risk, (3) reduce the risk of cash misappropriation related to receipts for unrecorded receivables, and (4) create and maintain a single customer database that can track customer attributes such as creditworthiness, negotiated payment terms, or changes in contact information.

The University Accounting Manual sets forth general principles related to recording and managing receivables[4], including:

- Prompt billing for reimbursement of expenses or fees arising from services provided.
- Completing all actions necessary for the preparation of the bill.
- Tracking information concerning the age of outstanding bills and claims allowing for overall control of accounts receivable and related reserves for bad debts.

We observed that four of the five (80%) departments in our testing did not create, record and monitor receivables in the campus general ledger. Instead, they created invoices using manual systems such as word processing software to create invoices and spreadsheets to track the aging and status of invoices issued. Although no invoice is recorded in the general ledger, revenue is recorded when the campus receives and records the customer payment.

We believe financial and fraud risk related to receivables could be reduced by requiring units and departments to record their receivables in the general ledger at the time they are issued to the customer, allowing for better monitoring of aging and doubtful accounts. Simultaneously, the risk of errors with manual invoice entry and tracking would be reduced.

We understand that with the implementation of the PeopleSoft billing and accounts receivable modules in BFS 9.0 there are opportunities to train units and departments on setting up their customers, generating invoices using standard campus templates, and monitoring the aging of their receivables.

Management Response and Action Plan

We agree with the observation that the implementation of the PeopleSoft Billing and Accounts Receivable modules in BFS9.0 provides an opportunity for campus departments to use an enterprise-wide system based on modern technology to invoice customers, to record receivables in

[4] University of California, Accounting Manual, Receivables Management, R-212.

the general ledger, and to monitor and report on activities such as recovery, collections, aging, and write-off. To enforce this activity, the Controller's Office will issue a campus-wide policy requiring the use of the system for all appropriate UC Regent receivables generated by campus departments. The policy will be issued by July 1, 2013.

Enhance Processes for Unrelated Business Income

Observation

If revenue agreements with external parties result in gross income (revenue) from an unrelated trade or business activity regularly pursued by the University, it may be subject to unrelated business income taxes (UBIT) which would be reported on the University's Exempt Organization Business Income Tax Return (IRS Form 990-T).[5]

Under University policy[6], department heads have been assigned responsibility for compliance with UBIT including the following specific responsibilities:

- Familiarize themselves with unrelated business income guidelines.
- Notify the campus tax coordinator (or appropriate person) about activities which generate over $10,000 of outside revenue.
- Consult with the campus tax coordinator (or appropriate person) when planning an activity that has unrelated business income tax potential.
- Ensure that costs associated with teaching, research, or other exempt activities of the department are not allocated to the publication activities.

We discussed the current implementation of BFB A-61 with General Accounting, which functions as the campus tax coordinator and provides local campus guidance on UBIT on their website. In practice, they note that General Accounting receives few inquiries related to UBIT from departments, which may reflect low UBIT-related activity or alternatively low levels of awareness among departments of the requirement to consult proactively on activity potentially subject to UBIT. General Accounting notes, given the latter possibility, that they conduct their own periodic analytical procedures to try to identify revenue trends that may be indicators of new or changes in revenue activity potentially subject to UBIT.

Although we did not identify activities in our sampled agreements that were potentially subject to UBIT, we observed an opportunity to reduce compliance risk and improve business processes if BCO were to include in their contract vetting process a consideration of the types of revenue activity that are in proposed agreements that may be potentially subject to UBIT. They may then advise the department to complete the UBIT evaluation form and notify General Accounting to expect a completed form. If the activity is deemed subject to UBIT, General Accounting can then work with the unit to ensure that revenue and related expenses are tracked and matched for reporting purposes.

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[5] University of California, BFB A-61, Policy on Unrelated Business Income and Expenses, January 17, 2012.

[6] University of California, BFB A-61, Policy on Unrelated Business Income and Expenses, January 17, 2012.

Management Response and Action Plan

BCO contract specialists review, draft, and negotiate business contracts but ongoing contract management resides with the department. Identifying and reporting UBIT is a part of the contract management process and contract administrators should work directly with General Accounting personnel who have UBIT expertise to identify revenue that might be subject to UBIT.

As noted in the management response and action plan for Pricing External Contracts to Fully Recover Direct and Indirect Costs: "The campus under the direction of VCAF is establishing within the Operational Excellence Program Office [OEPO] a 'Revenue Generating Initiative.' This will provide a formal review for entities looking to engage in entrepreneurial activities to generate revenue to support core mission items." The OEPO "will be providing technical help and financing to units on campus that have well formulated revenue generating projects." It may therefore be more appropriate for OEPO to provide guidelines associated with UBIT, as they plan to do for "pricing, relative to indirect cost recovery" following consultation with General Accounting.

In the meantime, information about UBIT, with a link to the Unrelated Business Income Tax webpage, will be added to the BCO website by July 1, 2013.

Evaluation and Approval of the Revenue Agreement by the Appropriate Central Campus Office

Observation

Revenue agreements with external parties require concurrent approval by the individual unit as well as a central campus office. Depending on the terms of the agreement and the services the campus expects to provide, approval could come from one of three units:

- The Business Contracts Office (BCO)
- The Sponsored Projects Office (SPO)
- The Industry Alliances Office (IAO)

Generally, SPO approves agreements where there is an external government or private sponsor for research, whereas IAO is involved in agreements with industry consortia – both types of agreements that we have scoped out of this audit. BCO typically approves all remaining revenue agreements.

Although the three offices have coordinated in the past to further define what types of revenue agreements each has the authority to approve, we did note that some of the units in our sample felt that they were passed back and forth between BCO and SPO in terms of receiving advice on their revenue agreements as the two offices determined who had the proper approval jurisdiction over the agreement, creating delays in the approval process.

We recognize that the campus may periodically receive service requests generating external revenue that are complex and it is difficult to determine the appropriate central office for campus review. Therefore, we observed an opportunity to further enhance escalation procedures whereby complex, higher profile contracts are jointly discussed between BCO, SPO and/or IAO and a contract vetting approach is developed and agreed to early in the opportunity pursuit, reducing the likelihood of delays in approvals or questions about the appropriateness of the unit providing approvals after the fact.

Prior to the start of this audit, personnel from the following departments recognized the problem and began convening with the intent of coming up with a solution to this problem:

- BCO
- SPO
- IAO
- Office of Marketing & Business Outreach
- Research Administration and Compliance
- Office of Intellectual Property & Industry Research Alliances
- Office of Legal Affairs.

At the time of this audit, the workgroup was working on the design of the process improvement, an integrated process between the three offices (i.e., BCO, SPO, and IAO) including a resolution process if there was a disagreement concerning who is the appropriate office.

Management Response and Action Plan

SPO, IAO, and BCO are aware of and have been working collaboratively to reduce confusion surrounding the appropriate authority to review campus revenue agreements. Representatives from each of these departments meet regularly to establish criteria and a process for reviewing agreements that may be ambiguous or require expertise from multiple contracting parties. The "Who Does What" guide is being developed to help in identifying the criteria and process. The guide also provides for a review process by a Project Analysis and Resolution Committee (PARC) which has been tasked to reach consensus regarding the final review process for these agreements. The members of PARC include representatives of SPO, IAO, BCO, and the Office of Legal Affairs. Primary and alternate members have been identified from each of the respective control units.

Since contracts can evolve during any review process, it may not be possible to eliminate completely the flow of agreements among departments; however, development of the aforementioned process and communication plans should mitigate delays in contract processing.

Lastly, it is the group's intention to review and update policy as necessary to clarify criteria and/or address any overlap of responsibilities.

The above will be implemented by October 1, 2013.