UNIVERSITY OF CALIFORNIA, DAVIS
INTERNAL AUDIT SERVICES

Development and Alumni Relations Donor Restrictions on Gift Expenditures Project #13-04

November 2013

Fieldwork Performed by:

Sherrill Jenkins, Principal Auditor

Reviewed by:

Tony Firpo, Principal Auditor
Leslyn Kraus, Associate Director

Approved by:

Jeremiah Maher, Director

Development and Alumni Relations
Donor Restrictions on Gift Expenditures
Internal Audit Services Project #13-04

MANAGEMENT SUMMARY

BACKGROUND

As part of the Internal Audit Services (IAS) audit plan for fiscal year (FY) 2013, IAS conducted a review of donor restrictions on gift expenditures. In FY 2013, UC Davis received approximately $80 million in restricted gifts and expendable endowment income, and spent approximately $65 million, as follows:

Fund Type	Income	Expense
Private restricted gifts	$49,363,815	$36,839,102
Regents' endowment income	23,870,885	21,987,744
Foundation endowment income	6,604,387	5,612,602
Total	**$79,839,087**	**$64,439,448**

Restricted gifts and endowments are commonly donated to the university to support research activity, scholarships, and academic support such as endowed chairs.

SCOPE

We assessed the risk associated with each funding type, and concluded that expendable endowment income represents the most significant risk. Our assessment was based on the fact that for endowment income, the associated endowment corpus could be at risk as well if the donor restrictions are not adhered to. As of 6/30/13, the total value of the UC Davis endowment (Regents and Foundation) was approximately $790 million. The focus of the detailed expenditure testing for the audit was therefore on FY 2013 spending activity for the Regents' and Foundation endowment income funds. However, other procedures performed addressed both spending of endowment income and restricted gifts, since departments surveyed (as explained below) confirmed that controls are the same for restricted gifts and endowment income expenditures. The Division of Agriculture and Natural Resources was not included within the scope of our review.

PURPOSE

The purpose of this review was threefold: (1) to evaluate policies, procedures and practices that ensure spending of restricted gift and endowment funds is in accordance with donor terms; (2) to assess the oversight of the spending of endowment income; and (3) to conduct detailed testing of expenditures of endowment income for compliance with donor restrictions on a sample basis.

PROCEDURES PERFORMED

At UC Davis, the oversight for the spending of endowment income is decentralized, and responsibility falls to the individual schools, colleges and business units.[1] To obtain an understanding of the current level of oversight within the schools and colleges, we surveyed account managers and principal investigators (PIs) associated with endowment funds that had expenditures exceeding $10,000 in FY 2013. Of the account managers, 98 (74%) responded to our survey, and of the PIs, 69 (61%) responded.

For detailed testing of expenditures, we selected a sample of 57 active endowment funds and reviewed a total of $4 million of expenditures from these funds to determine if the expenditures were in accordance with donor restrictions. For each fund, we also evaluated the oversight structure within the business unit spending the endowment income and assessed the account purpose description.

For benchmarking purposes, we contacted six other universities to identify best practices for oversight of endowment spending that may be useful to UC Davis as our fundraising efforts continue to advance.

Finally, we analyzed aggregate accumulated balances of endowment income funds, as well as the Gift Assessment Fee Fund associated with the campus' 6% administrative fee on all gifts, to evaluate the timeliness of expending these funds.

CONCLUSION

Our survey indicated that the account managers and PIs who responded are confident that spending is in accordance with donor restrictions. However, survey respondents also indicated they would like additional training regarding restricted gifts and endowments. (A summary of the survey results is included as Appendix A to this report.)

Our review of the 57 funds and $4 million in expenditures disclosed only minor instances of non-compliance with donor restrictions totaling approximately $6,000. We found 49 (86%) of the 57 funds had an oversight structure at the unit level that included either the PI or Chair in the pre-approval or post-approval process or oversight was provided through a committee (e.g., in awarding scholarships). However, we also found that the account purpose description often used by transaction processors and approvers to identify donor restrictions did not sufficiently describe those restrictions for approximately 19% of the accounts reviewed. Overall, the decentralized oversight at the unit level for the funds reviewed was satisfactory to provide reasonable assurance that donor funds are being spent in accordance with donor terms for those funds.

Our benchmarking study found that three of our peer institutions rely on a centralized on-going review activity of some type to help ensure expenditures of endowment income are in accordance with donor restrictions. (A summary of the benchmarking results is included as Appendix B to this report.) Despite the fact that our review did not identify significant non-compliance with donor restrictions in the endowment funds

[1] The UC Davis Health System does provide for centralized monitoring of endowment income expenditures through Health Sciences Development.

tested, we believe UC Davis should consider establishing within Development and Alumni Relations (DEVAR) or the UC Davis Foundation a compliance function charged with providing centralized monitoring for the expenditure of endowment income funds. The risks associated with endowment income funds exceed the amount being expended, as an instance of non-compliance could result in damaged relations with the donor, a request for a return of the endowment corpus, and/or negative publicity that impacts future fundraising efforts. With the success of the recent Comprehensive Campaign, and the goal of increasing philanthropy, cultivation of donor relations and responsible, effective stewardship of funds, including expending of funds in accordance with donor-imposed restrictions, is essential.

We also identified that endowment income is accumulating in many funds beyond the five year period recommended by the University of California. As of 6/30/13, for endowment income funds with at least five years of activity (which total $36.3 million), $6.6 million has accumulated beyond five years.

Finally, within the overall fund associated with the 6% gift fee assessment, there is a net surplus balance of approximately $1.0 million as of 6/30/13 on a campus-wide basis. At the time of our review, management had not been informed of gift fee balances in the academic departments and business units that contributed to the surplus.

I. OBSERVATIONS, RECOMMENDATIONS, AND MANAGEMENT CORRECTIVE ACTIONS

A. Internal Compliance Function

As development efforts continue to grow, UC Davis may benefit from a centralized compliance function focused on reviewing expenditures from endowment income funds for conformity with donor-imposed restrictions.

The scope of our audit included a benchmarking survey of endowment expenditure monitoring practices at six institutions specified by DEVAR management. A detailed summary of the benchmarking survey results is included as Appendix B to this report. The table below lists the total approximate value of the endowments for UC Davis and the six institutions benchmarked.

University	Approximate Endowment (in ’000s)
Stanford University	$ 17,000,000
University of Southern California	3,500,000
University of California, Los Angeles	2,800,000
University of Washington	2,300,000
Michigan State University	1,600,000
University of California, Davis	790,000
Iowa State University	500,000

Three of the benchmarked institutions, Iowa State University, University of California, Los Angeles and Stanford University provided for ongoing centralized oversight of expenditures of income from endowment funds through a program of reviews (or audits) by the Foundation, Internal Audit and the Fund Accounting Division, respectively. An additional institution, University of Washington, was in the beginning stages of developing web based tools which would allow donors to review documentation related to expenditures of gift funds and essentially perform their own audits.

Both Michigan State University and University of Washington rely on their internal auditors to provide some level of oversight over expenditures of endowment income, though it appears to occur primarily as a part of a larger review of an academic or business unit. University of Southern California indicated that primary responsibility for endowment income spending rests with the academic or business unit. Follow-up on specific funds occurs if a problem is discovered.

UC Davis currently has a decentralized model for monitoring use of income from restricted endowment funds which is similar to University of Southern California. There is no central unit at UC Davis that is responsible for reviewing expenditures from endowment funds to determine adherence with restrictions imposed by donors. Additionally, Internal Audit Services does not regularly perform reviews of academic units that might incorporate testing of endowment income expenditures.

UC Davis recently announced that it has successfully reached its goal to raise $1 billion from more than 100,000 donors through its first comprehensive fundraising campaign, *The Campaign for UC Davis (*Campaign). With the success of the Campaign, and the goal of increasing philanthropy as UC Davis moves forward on implementation of the 2020 Initiative, cultivation of donor relations and responsible, effective stewardship of funds, including expending of funds in accordance with donor-imposed restrictions, is essential.

The establishment of a compliance function within the Foundation or DEVAR would represent a means of reducing the risk involved in potentially misspending funds subject to donor terms. In recent years, other universities have faced incidents involving loss of funds and negative publicity when donors demanded that endowment funds be returned because their funding restrictions had not been followed.

<u>Recommendations</u>

DEVAR should explore the possibility of establishing a compliance function, potentially comprised of UC Davis personnel and volunteers from the Foundation. This group should be tasked with the following:

- Performing risk assessments to identify endowments to be audited.
- Auditing expenditures for compliance with donor terms. Based on the results of the initial audits, parameters should be outlined for ongoing sample-based auditing.
- Preparing periodic reports to DEVAR management summarizing the results of its expenditure audits. DEVAR management should utilize these periodic reports to assess the value provided by the compliance group over time and make adjustments to the group’s size and responsibilities as necessary.
- Educating business units about the nature of restricted endowments and gifts.
- Advising business units about the type/format of information that should be distributed to donors regarding how their funds were expended.
- Providing reminders to business units stressing the importance of expending funds in accordance with donor restrictions.

Management Corrective Action

By September 15, 2014, DEVAR will complete a feasibility study regarding establishing a compliance function at UC Davis. The study will incorporate resources/costs necessary to address each of the recommendations noted above.

B. Accumulation of and Reporting on Endowment Income Funds

Endowment income in many funds is accumulating beyond the recommended period of five years and totals $6.6 million as of 6/30/13.

Responsible stewardship includes expending endowment income funds in a timely manner, and the University of California (UC) has recommended a standard that these funds should not accumulate beyond five years. The UC Accounting Manual section X.I.E-525.II.D states:

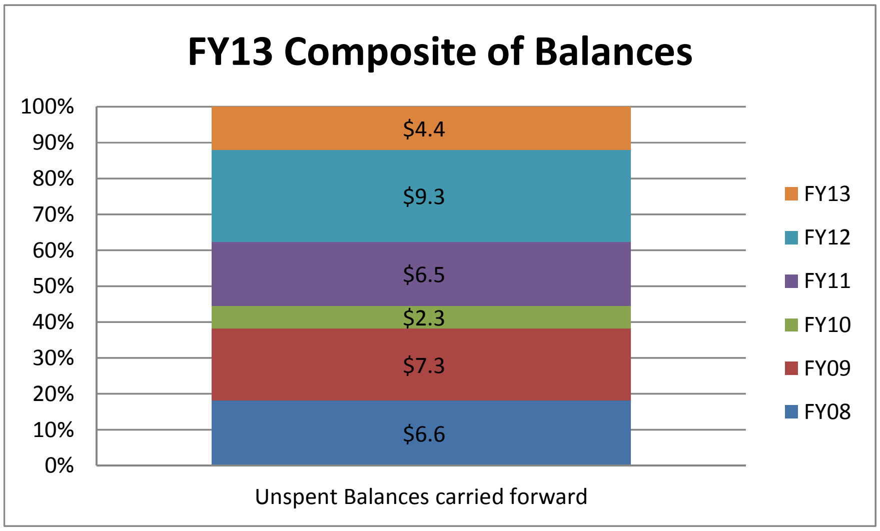
- The University is legally required to administer the endowment funds it has accepted, in accordance with all the terms imposed by the donor. Since an implied requirement of the law is the University must put endowment payout to use, income may not accumulate for an unreasonable period of time. To ensure compliance with this law, The Office of General Counsel (General Counsel) has recommended that endowment income should not be allowed to accumulate beyond five years.

To assess UC Davis' compliance with this UC standard, we performed an analysis of all Regents' and Foundation endowment income funds with at least five years of activity as of 6/30/13. In total, there are approximately 1,600 endowment income funds, and approximately 1,200 of these have at least five years of activity. Among these 1,200 funds, the total combined balance of accumulated income at 6/30/13 is approximately $36.4 million. Chart A below presents an "aging" of this $36.4 million balance, indicating that: (a) $6.6 million has already accumulated beyond five years;[2] (b) $7.3 million has already accumulated for four years[3]; and so forth for each of the years presented.

[2] Amount was calculated by subtracting expenses from the five year-period of FY 2009-2013 from the balance at 6/30/2008.
[3] Amount was calculated by subtracting expenses from the four-year period of FY 2010-2013 from the balance at 6/30/2009.

Chart A

FY 2013 year end balances for funds with 5 years of activity: $36.4 million.
Identifies carry forward balances from each fiscal year.



Of the 1,200 endowment funds referenced above, 45% have balances that are almost equal to or exceeding five years of income received in the fund. This group represents $16.3 million of the total $36.4 million in FY13 balances.

Of the $6.6 million that has accumulated beyond five years, 50% represents funds designated with the “organized research” higher education code, and 36% represents funds designated with the “academic support” (e.g., an endowed chair) code.

In analyzing the accumulation of funds, we learned that neither the Foundation nor DEVAR has been monitoring accumulated balances or communicating with campus departments about their balances since 2009. This lack of oversight and communication may have contributed to the accumulation of balances noted.

We contacted a small group of account managers to question why their account balances had been accumulating. Common reasons cited included: (a) a delay in setting up a scholarship program; (b) no developed plans to spend the funds; and (c) spending practices that approximate the annual income received, thereby not reducing the balance.

Recommendations

DEVAR should implement a program to begin monitoring fund balances that accumulate income and are not spent timely. Reporting of accumulated balances to departments should occur on a periodic basis. When accounts with accumulated funds above a certain threshold are identified, DEVAR should work with the department to determine why the condition exists, and to help identify a resolution and spending plan if necessary.

Finally, although this review focused primarily on endowment income funds rather than current use gifts, the information regarding restricted current use gifts that appears in the chart in the management summary indicates that income is exceeding expenditures and that, therefore, management may need to develop a campus-wide strategy for monitoring and spending current use gift funds in a timely manner as well.

Management Corrective Actions

The responsibility for reporting on accumulated balances in endowment income funds will be transitioned from the Administrative Services unit to the Donor Relations unit in DEVAR by September 15, 2014. Donor Relations will establish a procedure for reporting accumulated balances to departments on an annual basis. Reporting procedures will begin by March 15, 2015. After reporting procedures have been established, Donor Relations will implement a risk-based oversight program which will include monitoring of accumulated balances and communication with departments. The oversight program will be established by April 15, 2015.

C. Spending in Accordance with Donor-Imposed Restrictions

Our detailed audit testing encompassed 57 endowment funds and a total of approximately $4 million in FY 2013 expenditures, and we identified only approximately $6,000 from one fund that does not appear to be in accordance with donor-imposed restrictions.

Approximately $6,000 was expended from a fund whose spending parameters had been established by a departmental faculty oversight committee's interpretation of an endowment agreement. The $6,000 of expenditures was in line with the committee interpretation of the donor restrictions, but the committee interpretation does not appear to be in accordance with the written agreement from the donor. Non-compliance with donor restrictions may lead to adverse publicity for the University and damage to donor goodwill.

Recommendations

The $6,000 of inappropriate expenditures should be transferred to a different funding source.

DEVAR should work with the department to revise the faculty oversight committee guidelines to be consistent with documented donor requirements for use of the endowment fund.

Management Corrective Actions

The inappropriate expenditures identified will be transferred to an allowable funding source by February 15, 2014.

DEVAR will work with the department to update the guidelines for use of the endowment fund earnings by April 15, 2014.

D. Account Purpose Descriptions

The account "purpose" statements for many endowment income accounts do not include sufficient descriptions of donor-imposed restrictions, which may increase the risk of funds being spent inappropriately.

In the accounting system, every account includes a "purpose" statement that explains the nature of the account. In our survey, many account managers noted that they rely on the purpose statement as a control to identify expenditure restrictions for endowment income funds. However, 19% of the accounts within the 57 funds we reviewed included purpose statements that did not include sufficient details about the terms imposed by the donor. Because many account managers rely on the purpose statement, the risk of misspending endowment income funds may increase in cases where the purpose statement is not detailed enough.

In FY 2013, Extramural Funds Accounting (EFA) made a request to gift/endowment fiscal officers to revise their account purpose statements, if necessary, to help facilitate more accurate and efficient stewardship of funds. However, EFA had no means of determining which purpose statements were revised based upon their request; and as a result, no additional follow-up could be performed by EFA.

Recommendations

EFA should send out a follow-up communication to gift/endowment fiscal officers informing them of the audit findings and requesting that account purpose statements be reviewed and revised as necessary as transactions are processed in each endowment income/gift account.

See recommendation under Observation A above regarding the establishment of a compliance function. In its review of endowment funds, the compliance group should be responsible for establishing procedures to determine whether account purpose statements are satisfactory and perform follow-up reviews as necessary until purpose statements are updated.

Management Corrective Action

By May 15, 2014, EFA will send out a follow-up communication to gift/endowment fiscal officers to review and revise (where necessary) the account purpose statements for restricted gifts and endowments when insufficient purpose statements are identified during transaction processing.

Responsibility for monitoring the account purpose statements will be incorporated into the activities of the internal compliance function described in observation I.A. above.

E. Gift Fee Revenues

Certain gift fee revenue accounts have surpluses and deficits, some of which were unknown to campus leadership and DEVAR management.

Per Policy and Procedure Manual 260-50, *Gift Fee: Assessment and Distribution*, the campus assesses a 6% gift fee on all gifts to UC Davis, with limited exceptions. Two-thirds of the gift fee revenue on each gift is distributed directly to the school/college/unit that received the gift to support advancement activities, while one-third is distributed to a central campus pool for strategic allocation advancement-related purposes.

Within DaFIS, the two-thirds component and the one-third component of the gift assessment are both accounted for within a single UC Fund, and the overall balance of this UC Fund is approximately $1 million as of 6/30/13. However, the combined net balance within the accounts of the school/college/unit development offices associated with the two-thirds component is a surplus of approximately $3.5 million, while the central campus pool account associated with the one-third component has a deficit of approximately $2.5 million. (One school's development office has a surplus of approximately $1.3 million as of 6/30/13, while two others have surpluses approximating $500,000.)

Budget and Institutional Analysis (BIA) has had responsibility for reporting on gift fee revenues and is responsible for the central campus pool. BIA informed DEVAR and the Provost about the deficit in the central pool account approximately 18 months ago. Since that time, a plan to eliminate the deficit has been developed, and the deficit has been decreasing. However, the combined $3.5 million surplus in the departmental accounts was first identified during this audit because the UC Fund that includes all the gift fee-related accounts had not been analyzed on an overall basis. BIA periodically reports to the Provost and DEVAR, information about gift fees received and distributed to development offices; however, monitoring and reporting had not been done by BIA on the expenditures of these funds, so the surpluses at the departmental level had not been identified.

Recommendations

While BIA prepares campus wide reports, campus should also develop reporting tools and procedures to ensure that campus management, including the Provost and the Vice Chancellor for DEVAR are provided with timely and comprehensive information regarding the gift fee assessment fund. Information regarding fund balances in a particular school, college or business unit should also be provided to the appropriate Dean or Vice Chancellor. Balances in the gift fee fund should be considered by BIA in future decision making regarding funding for development initiatives in affected schools, colleges and business units.

Management Corrective Actions

BIA with DEVAR, A&FS and units will develop and provide reports to campus management detailing funds available at the unit level for the gift fee assessment fund by September 15, 2014, so the information is available for use in future funding decisions on development related initiatives.

Appendix A

Internal Survey on Oversight Practices

To assess the decentralized oversight provided over expenditures of restricted endowment income, we conducted a survey that asked questions related to; the level of oversight provided, how the persons responsible ensure the expenses are consistent with the donors' restrictions; and what tools they use to perform their duties.

We first identified all accounts associated with restricted endowment funds and with FY 2013 spending of greater than $10,000. We then identified the associated account managers and principal investigators. We contacted 132 account managers and 114 PIs encompassing 21 schools/colleges/business units and received responses from 98 accounts managers (74%) and 69 PIs (61%). The results of our survey yielded the following observations:

- Account managers and PIs represented that overall they are very confident that all spending of restricted endowment income under their responsibility is appropriate to the donors' restrictions.
- Account mangers and PIs rely primarily on their existing knowledge of the endowment fund and the donors' restrictions to ensure the spending is appropriate prior to their approval of transactions.
- In the majority of instances when PIs are associated with accounts, the PI takes the lead role for approval of transactions.
- Account managers reported they also rely on a strong communication channel between themselves and the transaction processors, allowing for questions and answers if needed.
- Account managers utilize Decision Support reports to help them monitor for overdrafts and the accumulation of income, while PIs mainly relied on the account managers to perform this monitoring.
- Less than 50% of the account managers responded that their department provides information about the spending to donors. Departments that do provide the information to donors, report they provide the total spending for the period and/or the type of purchases made or expenses incurred.
- 56% of the account managers reported they would like enhanced training from DEVAR. They suggested the following:
    - Targeted training on endowment/account types, STIP and payout systems.
    - How to monitor funds including accumulated balances.
    - How and what information to provide to donors.
    - How to project income for these funds.
    - Training to include best practices.
    - Better in-class training and website materials.
    - An online training module or e-training with pass/fail conditions.

- A majority of account managers and PIs responded that they would like to see enhanced monitoring tools developed to help them do a better job with their oversight responsibilities. They suggested the following:
    - Upgrades to our financial system to include:
        - Access by the processors or approvers to the documents or details that include the donors' restrictions.[4]
        - Field sizes capable of holding additional information about the donors' restrictions.
    - Enhanced financial reporting capabilities that could:
        - Provide information for more than one fund at a selection.[5]
        - Present the information in a bank account format.
        - Take the place of internal spreadsheets used by departments that provide more useful account activity to support monitoring.
    - Developed checklists for departmental use.
    - A newer more efficient financial system.
    - Consistent financial system across all UC campuses.
- 100% of the account managers responded that the oversight they provide over restricted endowments is the same as what they provide over restricted gifts.

[4] For Regents' endowments, documents are imaged and available through Decision Support report FIS262. Some account managers may not be aware of this resource.
[5] FIS348 was recently developed and released to the campus and can assist those with gift and endowment oversight. This report may also not be widely known about and includes the ability to list more than one fund at a time.

Appendix B

External Benchmarking of Oversight Best Practices

We benchmarked six institutions recommended by DEVAR management to obtain an understanding of practices they use to provide oversight for the spending activities relating to restricted endowment and gift income. The six institutions were: Stanford University; University of Southern California; University of California, Los Angeles; University of Michigan; University of Washington; and Iowa State University.

Three institutions provide for ongoing centralized monitoring of endowment expenditures:

- Iowa State University Foundation has a centralized unit, Donor Compliance Services, which is responsible for performing reviews of the endowment spending. The unit is comprised of four personnel. They have a database that holds their review findings and they report out to the campus management three to four times a year. This unit also performs the training and establishes the gift agreements.

- UCLA utilizes Internal Audit to perform an annual compliance review of the UCLA Foundation's restricted fund transfers to the University, and also to review a sampling of the expenditures from those funds for compliance with donor restrictions. This annual review has been conducted since 1984.

- At Stanford University the Fund Accounting unit is responsible for performing two to six reviews each year of spending from restricted endowment income accounts. Activity within the endowment accounts is compared to the donor restrictions, and a questionnaire is also completed by the business unit under review. A report is provided to the dean of the school or college under review.

Two other institutions rely on their internal auditors to provide some level of centralized oversight over endowment spending, though the audit work is generally part of a larger review of an academic or business unit.

- Michigan State University internal auditors may perform full endowment audits every five to seven years, but will include endowment activity when reviewing a specific academic unit.

- University of Washington internal auditors contact Donor Services to discuss possible areas of concern before they audit a particular school or division. However, University of Washington also reported they have created fund balance reports, and have scanned all gift related documents into an information system that can be accessed by those with processing and oversight responsibility. Additionally, University of Washington is in the beginning stages of designing a donor web portal, which will house all gift related documents, receipts, and spending reports. The portal will allow access to each fund by the associated donor and enable donors to perform their own audits.

One institution, University of Southern California, indicated that the schools or units are responsible for direct oversight. Annual reminders are sent to school/units about their responsibility to ensure that funds are spent in accordance with donor terms and that funds are being spent. There is some monitoring and follow up with departments when issues are discovered with expenditures.