

Report 16-3
February 2016

University of Wisconsin System

Fiscal Year 2014-15

STATE OF WISCONSIN



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University of Wisconsin System Fiscal Year 2014-15

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CONTENTS

Letter of Transmittal	1
Report Highlights	3
Introduction	9
UW System Board and Staff	9
Financial Condition	10
Revenue and Expenses	11
Debt Service Costs	13
Net Position	14
Affiliated Organizations	15
FY 2015-16 Budget Considerations	17
Program Revenue Balances Reporting	21
Program Revenue Balances Policy	21
FY 2014-15 Program Revenue Balances Report	23
Reserves Policies	27
Investments	31
Funds under Management	31
Organizational Structure	32
Composition of the Long Term and Intermediate Term Funds	33
Long Term Fund	33
Intermediate Term Fund	36
Administration of the Trust Funds	37
Monitoring of External Investment Managers	38
External Investment Management Fees	40
Investment Performance	42
Reports to the Board of Regents	46
Auditor's Report	49

OPINION PUBLISHED SEPARATELY

The financial statements and our unmodified opinion on them are included in the University of Wisconsin System's 2015 Annual Financial Report

Appendices

Appendix 1—UW System Affiliated Organizations

Appendix 2—Apportionment of GPR Offset, by Institution

Appendix 3—Level-of-Commitment Categories

Appendix 4—Selected Reporting Requirements for Unrestricted
Program Revenue Balances

Appendix 5—Summary of UW System Unrestricted Program Revenue Balances
by Level of Commitment

Appendix 6—Summary of External Investment Manager Performance

Response

From the University of Wisconsin System President



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Joe Chrisman
State Auditor

February 15, 2016

Senator Robert Cowles and
Representative Samantha Kerkman, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Cowles and Representative Kerkman:

As required by s. 13.94 (1) (t), Wis. Stats., we have completed a financial audit of the University of Wisconsin (UW) System. We have provided an unmodified opinion on UW System's fiscal year (FY) 2014-15 and FY 2013-14 financial statements. These financial statements and our audit opinion are included in UW System's *2015 Annual Financial Report*, which is available on its website.

On the basis of generally accepted accounting principles (GAAP), UW System's net position increased from \$6.3 billion as of June 30, 2014, to \$6.7 billion as of June 30, 2015, or by \$350.0 million. The increase in net position is primarily the result of UW System's implementation of new pension accounting standards that required UW System to report a net pension asset. The net pension asset is not available to meet UW System's other obligations.

As of June 30, 2015, the unrestricted program revenue balance for all UW institutions was \$923.9 million on a budgetary basis, or \$49.4 million less than the balance as of June 30, 2014. Although UW System Administration implemented our recommendations from report 15-1 to improve its program revenue balances reporting, we again identified concerns with UW institution reserves policies, and we include additional recommendations for improvement.

Donors may make gifts, grants, or bequests to the Board of Regents or to an individual UW institution. As of June 30, 2015, UW System held \$523.4 million in such investments, most of which was invested by external investment managers. We reviewed the policies used to manage these investments, and we include several recommendations to improve oversight and administration.

We identified weaknesses in information technology security policies, procedures, and controls for several UW institutions. Because such weaknesses increase the risk that unauthorized or erroneous transactions could be processed; accounting, payroll, and student data could be changed; or personally identifiable information could be accidentally or maliciously exposed, we considered these weaknesses to be a significant deficiency in internal control in our Independent Auditor's Report on Internal Control and on Compliance and Other Matters, which begins on page 51.

We appreciate the courtesy and cooperation extended to us by staff of UW System during the audit. A response from the UW System President follows the appendices.

Respectfully submitted,

Joe Chrisman
State Auditor

JC/CS/ss

Report Highlights ■

On the basis of generally accepted accounting principles (GAAP), UW System's net position was \$6.7 billion as of June 30, 2015.

We identified weaknesses in information technology security policies, procedures, and controls at several UW institutions.

2015 Wisconsin Act 55 included a base budget reduction in GPR appropriated to UW System.

Additional review and guidance is needed related to reserves policies developed by UW institutions.

UW System Administration did not complete ongoing due diligence of its external investment managers in accordance with its policies.

The University of Wisconsin (UW) System provides postsecondary academic education for approximately 181,000 students. UW System consists of 13 four-year universities, 13 two-year colleges, UW-Extension, and UW System Administration. Under ch. 36, Wis. Stats., UW System is governed by the 18-member Board of Regents, which is responsible for appointing the UW System President, the chancellors of each of the 13 four-year universities, the chancellor of UW-Extension and Colleges, and the deans who head the two-year colleges.

We are required by statute to perform an annual financial audit of UW System. Our unmodified opinion on UW System's financial statements for fiscal year (FY) 2014-15 and FY 2013-14 is included in its *2015 Annual Financial Report*. In completing our audit, we:

- reviewed UW System's overall financial condition;
- analyzed how UW System Administration apportioned a base budget reduction in general purpose revenue (GPR) appropriated by 2015 Wisconsin Act 55, the 2015-17 Biennial Budget Act, to UW institutions for FY 2015-16;
- performed a limited review of the FY 2014-15 program revenue balances report, which was submitted to the Board of Regents and the Legislature in October 2015; and

- evaluated the role of UW System Administration’s Office of Trust Funds in overseeing investment of gifts, grants, and bequests made to the Board of Regents or individual UW institutions.

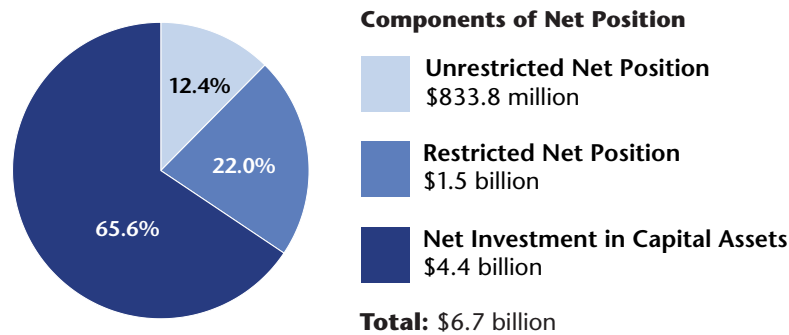
Financial Condition

In FY 2014-15, and on the basis of generally accepted accounting principles (GAAP), UW System revenue totaled \$4.9 billion and the largest revenue was Student Tuition and Fees, which totaled \$1.2 billion and was 24.0 percent of total revenue. UW System expenses totaled \$4.8 billion and the largest expense was Salary and Fringe Benefits, which totaled \$3.0 billion and was 63.0 percent of total expenses.

As of June 30, 2015, UW System’s net position, which provides a measure of its overall financial condition, was \$6.7 billion on a GAAP basis. As shown in Figure 1, Unrestricted Net Position, which are resources available for future spending, was \$833.8 million as of June 30, 2015.

Figure 1

Net Position¹ As of June 30, 2015



¹ On the basis of generally accepted accounting principles (GAAP).

We identified weaknesses in information technology (IT) security policies, procedures, and controls for several applications at several UW institutions. These weaknesses increase the risk that unauthorized or erroneous transactions could be processed;

accounting, payroll, and student data could be changed; or personally identifiable information could be accidentally or maliciously exposed. We considered these weaknesses to be a significant deficiency in internal control for FY 2014-15.

For each year in the 2015-17 biennium, 2015 Wisconsin Act 55, the Biennial Budget Act, included a \$150.0 million reduction in GPR appropriated to UW System for general program operations, which include the salaries, fringe benefits, utilities, and supplies and services used to provide an education to students enrolled at UW institutions. In addition, Act 55 provided \$25.0 million in GPR in each year of the biennium to offset the reduction. UW System reported taking a number of actions in FY 2015-16 in response to the reduction in GPR, including distributing \$20.0 million in UW Systemwide program revenue balances to UW institutions.

Program Revenue Balances

As of June 30, 2015, UW System's total program revenue balance was \$1.2 billion. During the Board of Regents October 2015 meeting, UW System Administration reported to the Board the fiscal year-end balances for each institution for program revenue funding sources that did not have a restriction on their use, such as tuition and federal indirect cost reimbursement. On a budgetary basis, these balances decreased from \$973.3 million as of June 30, 2014, to \$923.9 million as of June 30, 2015, or by \$49.4 million.

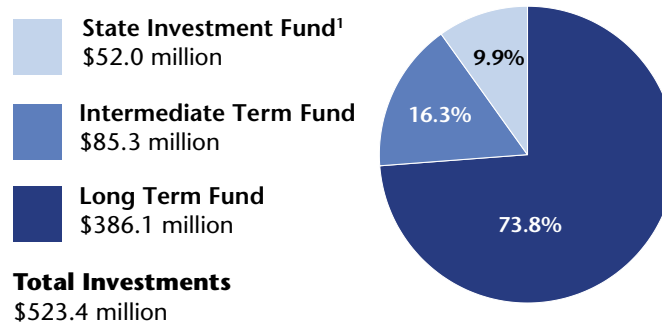
UW System took steps to address recommendations we included in report 15-1 to improve its program revenue balances report. However, additional review and guidance is needed related to the reserves policies developed by UW institutions.

Investments

The Board of Regents is responsible for investing all gifts, grants, and bequests made to the Board of Regents or to individual UW institutions. UW System Administration's Office of Trust Funds is responsible for the daily management and administration of the trust funds. As of June 30, 2015, UW System held \$523.4 million in such investments. As shown in Figure 2, most of these investments are in the Long Term Fund, which is used to invest endowed assets, and the Intermediate Term Fund, which is used to invest fully expendable assets. We reviewed the role of the Board of Regents and UW System Administration's Office of Trust Funds in overseeing the investment of these funds, and the policies used to manage the investments.

Figure 2

Total Investments
As of June 30, 2015



¹ Short-term pool of state and local government funds managed by the State of Wisconsin Investment Board.

Approximately 82.0 percent of the assets in the Long Term and Intermediate Term funds are managed by external investment managers. We found the Office of Trust Funds did not conduct required due diligence meetings for two of six external investment managers in 2015 and that documentation to support ongoing due diligence was not always available. In addition, we found the Office of Trust Funds did not prepare required reports to the Board of Regents related to due diligence activity that it performed.

External investment managers charge a fee to UW System Administration for investment management services. In FY 2014-15, external investment management fees totaled \$3.1 million, of which \$1.4 million was directly billed to UW System and \$1.7 million was charged against investment earnings. We found the Office of Trust Funds did not monitor the fees charged against investment earnings to ensure they complied with the terms of the contracts with the external investment managers.

Recommendations

We recommend UW System Administration review current UW institution reserves policies to ensure the policies are complete and consistently in compliance with Board of Regents policies and UW System Administration guidance ([p. 29](#)).

We also recommend UW System Administration:

- ☑ review the asset allocation plans for investments to determine if changes should be made, report the results of its review to the Board of Regents, and seek approval of any revisions (*p. 37*);
- ☑ improve its current processes to ensure that ongoing due diligence of external investment managers is being completed and documented in accordance with the UW System Trust Funds Investment Policy Statement (*p. 39*);
- ☑ complete and provide an annual due diligence report for each external investment manager to the Board of Regents Business and Finance Committee, as required by the UW System Trust Funds Investment Policy Statement (*p. 39*);
- ☑ request from each external investment manager, on at least an annual basis, information on the actual investment management fees charged against investment earnings and compare fees to the terms of the contracts to ensure UW System is paying the correct amount of fees (*p. 42*);
- ☑ report the results of its review of investment management fees to the Board of Regents on an annual basis (*p. 42*);
- ☑ review the benchmarks used to assess and report on investment performance of the Intermediate Term Fund, determine if an alternative benchmark should be used, and report to the Board of Regents the results of the review and propose any changes to be made (*p. 46*); and
- ☑ improve the content and the availability of its investment reports to the Board of Regents (*p. 47*).

We recommend UW System Administration report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations (*pp. 29, 37, 39, 42, 46, and 47*).

Further, we recommend UW System Administration assist UW institutions in implementing changes to IT controls and develop a UW System-wide IT security program (*p. 54*).

Introduction ■

UW System provides postsecondary academic education for approximately 181,000 students. The System includes 13 four-year universities, 13 two-year colleges, UW-Extension, and UW System Administration. Each of the 13 universities awards bachelor's and master's degrees, and several also confer doctoral degrees. UW Colleges are the 13 two-year campuses, which offer general education associate degrees and course credits that transfer to other degree-granting universities. UW-Extension, in cooperation with other UW institutions, provides continuing education courses in classrooms and via distance education, as well as public service programs to Wisconsin residents. UW System Administration consists of the UW System President's staff who assist the Board of Regents in establishing and monitoring systemwide policies, financial planning for the system, and maintaining fiscal control.

UW System Board and Staff

Under s. 15.91, Wis. Stats., the Board of Regents members include:

- 14 citizen members;
- 2 student members, one of whom is a nontraditional student;
- the State Superintendent of Public Instruction; and
- the President of the Wisconsin Technical College System Board, or his or her designee.

Citizen and student members are appointed by the Governor and confirmed by the Senate. Citizen members are appointed for staggered seven-year terms, and student members are appointed for two-year terms. At least one citizen member must reside in each of the State's congressional districts.

The Board of Regents establishes policies to govern UW institutions.

The 18-member Board of Regents establishes policies to govern UW institutions. The Board is responsible for appointing the President of UW System, the chancellors of each of the 13 four-year universities, the chancellor of UW-Extension and Colleges, and the deans of the two-year colleges. The UW System President and the chancellors of each UW institution are responsible for implementing policies established by the Board of Regents. Each chancellor is responsible for the institution's operations, including financial administration.

Financial Condition

We provided an unmodified audit opinion on UW System's financial statements for FY 2014-15 and FY 2013-14.

As required by s. 13.94 (1) (t), Wis. Stats., we completed a financial audit of UW System. We audited UW System's financial statements for the years ended June 30, 2015, and June 30, 2014, and provided our unmodified audit opinion to UW System for inclusion in its *2015 Annual Financial Report*, which is available on its website. UW System's financial statements were prepared using generally accepted accounting principles (GAAP) prescribed by the Governmental Accounting Standards Board (GASB) and include the financial activity of all UW institutions. As a state agency, UW System's financial information is also included in the State's Comprehensive Annual Financial Report (CAFR).

We report a significant deficiency in internal control related to weaknesses in IT security policies, procedures, and controls at several UW institutions.

Our audit identified weaknesses in IT security policies, procedures, and controls for several computer applications at several UW institutions. Weaknesses in IT security policies, procedures, and controls increase the risk that unauthorized or erroneous transactions could be processed; accounting, payroll, and student data could be changed; or personally identifiable information could be accidentally or maliciously exposed. We determined that the detailed results of our review were too sensitive to communicate publicly. Therefore, we communicated the concerns to the institutions involved through confidential interim memoranda. We considered these weaknesses to be a significant deficiency in internal control in our Independent Auditor's Report on Internal Control and on Compliance and Other Matters, which begins on page 51.

Revenue and Expenses

Student Tuition and Fees accounted for 24.0 percent of UW System's total revenue in FY 2014-15.

As shown in Table 1, UW System revenue increased by less than 1.0 percent from FY 2013-14 and was \$4.9 billion again in FY 2014-15. During FY 2014-15, UW System's largest revenue was Student Tuition and Fees, which includes tuition and other academic student fees. The \$1.2 billion in Student Tuition and Fees UW System collected in FY 2014-15 was 24.0 percent of its total revenue. From FY 2013-14 through FY 2014-15, revenue from Student Tuition and Fees reported in UW System's financial statements increased by 2.7 percent. This increase was largely the result of a FY 2013-14 financial reporting error that UW System chose not to correct because it was immaterial to the financial statements overall.

Table 1

UW System Revenue¹ (in millions)

Financial Statement Account	FY 2014-15	FY 2013-14	Percentage Change
Student Tuition and Fees ²	\$1,169.2	\$1,138.3	2.7% ³
State Appropriations ⁴	896.6	918.7	(2.4)
Federal Grants and Contracts	759.2	804.2	(5.6)
Sales and Services of Auxiliary Enterprises ²	401.8	405.7	(1.0)
State, Local, and Private Grants and Contracts	389.5	358.3	8.7
Sales and Services of Educational Activities	327.8	312.0	5.1
Other Operating Revenue	327.3	318.8	2.7
Gifts	304.9	292.3	4.3
Capital Appropriations	157.5	94.5	66.7
Sales and Services to UW Hospital Authority	64.4	65.2	(1.2)
Other Nonoperating Revenue	47.2	96.9	(51.3)
Capital Contributions	31.0	46.5	(33.3)
Student Loan Interest Income and Fees	5.0	5.1	(2.0)
Total	\$4,881.4	\$4,856.5	0.5

¹ On the basis of generally accepted accounting principles (GAAP).

² Excludes scholarships and fellowships applied to student accounts.

³ This increase was largely the result of a FY 2013-14 financial reporting error that UW System chose not to correct because it was immaterial to the financial statements overall.

⁴ Excludes GPR appropriated to UW System for debt service payments.

State Appropriations was UW System's second-largest revenue during FY 2014-15. Except for GPR appropriated to UW System for its debt service payments, GPR that UW System received was reported on UW System's financial statements as State Appropriations. In FY 2014-15, State Appropriations totaled \$896.6 million and accounted for 18.4 percent of total revenue. From FY 2013-14 through FY 2014-15, State Appropriations decreased by \$22.1 million, or by 2.4 percent.

Federal Grants and Contracts totaled \$759.2 million in FY 2014-15 and accounted for 15.6 percent of UW System's total revenue. Other significant revenue for UW System in FY 2014-15 included:

- Sales and Services of Auxiliary Enterprises, which totaled \$401.8 million and included revenue received for services such as student housing and food service;
- State, Local, and Private Grants and Contracts, which totaled \$389.5 million and included grants and contracts received from other state agencies, Wisconsin municipalities, and other nonfederal entities;
- Sales and Services of Educational Activities, which totaled \$327.8 million and included revenue received from the sales of goods or services that were incidental to the primary function of UW System, such as textbook rentals, laboratory fees, scientific and literary publications, and public service programs;
- Other Operating Revenue, which totaled \$327.3 million and included revenue from intercollegiate athletics, student health services, child care centers, and certain administrative services; and
- Gifts, which totaled \$304.9 million and included amounts received from donors.

As shown in Table 2, UW System expenses decreased by less than 1.0 percent from FY 2013-14 and again totaled \$4.8 billion in FY 2014-15.

Table 2
UW System Expenses¹
(in millions)

Financial Statement Account	FY 2014-15	FY 2013-14	Percentage Change
Salary and Fringe Benefits	\$3,034.3	\$2,969.4	2.2%
Supplies and Services	1,178.0	1,227.6	(4.0)
Depreciation	290.4	273.5	6.2
Scholarships and Fellowships	135.8	149.6	(9.2)
Transfer to State Agencies	73.5	94.9	(22.6)
Interest on Indebtedness	55.9	62.6	(10.7)
Other Operating Expenses	31.4	30.2	4.0
Loss on Disposal of Capital Assets	17.4	25.6	(32.0)
Total	\$4,816.7	\$4,833.4	(0.3)

¹ On the basis of generally accepted accounting principles (GAAP).

Salary and Fringe Benefits was UW System's largest expense and totaled \$3.0 billion in FY 2014-15.

Salary and Fringe Benefits was UW System's largest expense and totaled \$3.0 billion, or 63.0 percent of its total expenses in FY 2014-15. Other significant expenses included those related to the purchase of supplies and services, depreciation on capital assets, and scholarships and fellowships.

Debt Service Costs

The State of Wisconsin issues debt on behalf of UW System, as it does for other state agencies. The proceeds of this debt are used to acquire or build facilities and other capital assets. Debt on academic facilities is repaid using GPR appropriated to UW System for that purpose. Debt on other facilities, such as residence halls, is repaid using program revenue that is generated by payments from users of these facilities.

Outstanding GPR-funded debt, which is paid by the State for academic facilities, was \$1.7 billion as of June 30, 2015.

In FY 2014-15, GPR-funded debt service payments totaled \$189.3 million and program revenue-funded debt service payments totaled \$127.0 million. As of both June 30, 2015, and June 30, 2014, outstanding GPR-funded debt totaled \$1.7 billion, and outstanding program revenue-funded debt totaled \$1.6 billion.

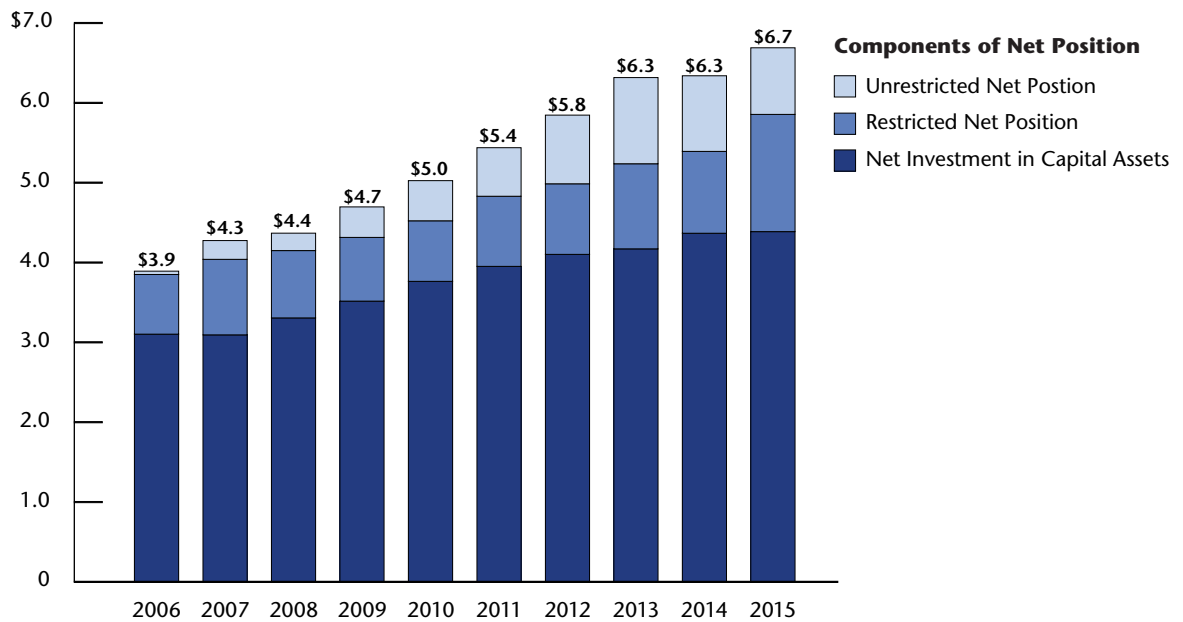
Net Position

UW System’s net position was \$6.7 billion as of June 30, 2015.

Net position provides a measure of overall financial condition. On a GAAP basis, UW System’s net position increased from \$6.3 billion as of June 30, 2014, to \$6.7 billion as of June 30, 2015, as shown in Figure 3. On UW System’s financial statements, net position was presented in three components: Net Investment in Capital Assets, Restricted Net Position, and Unrestricted Net Position.

Figure 3

Net Position of UW System¹
As of June 30
(in billions)



¹ On the basis of generally accepted accounting principles (GAAP).

Net Investment in Capital Assets represents capital assets, such as buildings and equipment, less accumulated depreciation, and less any related outstanding debt needed to purchase or construct these capital assets. Net Investment in Capital Assets was the largest component of UW System’s net position and totaled \$4.4 billion as of both June 30, 2015, and June 30, 2014.

Restricted Net Position represents amounts that have an external restriction on their use. The majority of UW System’s Restricted Net Position relates to amounts that were restricted for pensions,

endowment funds, gifts, nonfederal grants and contracts, and federal student loans. Restricted Net Position increased from \$1.0 billion as of June 30, 2014, to \$1.5 billion as of June 30, 2015, or by 43.2 percent. This increase resulted largely from the implementation of new pension accounting standards, which we discussed in report 15-11, that required UW System to report a net pension asset of \$330.2 million. The net pension asset is not available to meet UW System's other obligations because the Wisconsin Retirement System is an irrevocable trust and these funds can only be used to fund pension benefits.

On a GAAP basis, UW System's Unrestricted Net Position was \$833.8 million as of June 30, 2015.

Unrestricted Net Position represents any remaining amounts not otherwise included in Net Investment in Capital Assets or Restricted Net Position. These amounts are available to UW System for future spending. UW System indicated that most of its Unrestricted Net Position will be used for academic and research programs and initiatives, and capital programs. Unrestricted Net Position decreased from \$947.5 million as of June 30, 2014, to \$833.8 million as of June 30, 2015, or by \$113.7 million.

Student Tuition and Fees represented 43.6 percent of Unrestricted Net Position as of June 30, 2015.

Prior to FY 2013-14, UW System's Unrestricted Net Position increased steadily because UW System collected more revenue than it used in its operations. This increase in Unrestricted Net Position was largely attributable to unspent balances from Student Tuition and Fees. Unrestricted Net Position related to Student Tuition and Fees decreased from \$439.0 million as of June 30, 2014, to \$363.5 million as of June 30, 2015, or by \$75.5 million. Student tuition and fees represented 46.3 percent of Unrestricted Net Position as of June 30, 2014, and 43.6 percent of Unrestricted Net Position as of June 30, 2015. Other components of Unrestricted Net Position included general operations receipts, auxiliary operations not funded with student fees, and federal indirect cost reimbursement.

Affiliated Organizations

UW System Administration identified 74 affiliated organizations, such as booster clubs, alumni organizations, and foundations.

Under the provisions of GASB Statements 14, 39, and 61, UW System Administration is required to assess affiliated organizations on the basis of several factors, such as the legal status of the organization and the financial significance of the organization to UW System. For FY 2014-15 financial reporting purposes, UW System identified 74 such affiliated organizations, which include booster clubs, alumni organizations, and foundations. Since FY 2013-14, UW System identified three new affiliated organizations, and considered two organizations to no longer be affiliated organizations. Generally, because these organizations are separate legal entities, UW System does not control or have direct access to the funds held by these

organizations. Appendix 1 lists all UW System affiliated organizations identified by UW System Administration.

UW System Administration has determined that an affiliated organization is financially significant for financial reporting purposes if its total net assets, or net position, is greater than or equal to 5.0 percent of UW System's net position in the previous fiscal year. For FY 2014-15, UW System Administration considered an affiliated organization with net assets or net position of \$317.0 million or greater to be financially significant to UW System for financial reporting purposes. The affiliated organizations with the largest net assets or net position are UW Foundation, Wisconsin Alumni Research Foundation (WARF), and UW Medical Foundation.

UW Foundation's condensed financial statements are included in UW System's 2015 Annual Financial Report.

UW System Administration has determined that UW Foundation is financially significant. UW Foundation raises funds, receives gifts, and manages its investments primarily for the benefit of UW-Madison. Disbursements to and on behalf of UW-Madison are for scientific, literary, educational, and athletic purposes. UW System Administration included UW Foundation's Condensed Statement of Net Position and Condensed Statement of Activities in Note 11 of its *2015 Annual Financial Report*. UW Foundation's net position was \$2.9 billion as of December 31, 2014, and it contributed \$246.7 million primarily to UW-Madison during the fiscal year ended December 31, 2014.

WARF patents and licenses discoveries by UW-Madison researchers and uses income generated from the invested licensing revenues to fund additional UW-Madison research. In addition, WARF and UW-Madison jointly own the Wisconsin Institutes for Discovery. According to WARF's most recent publicly available Internal Revenue Service (IRS) Form 990, WARF had net assets of \$2.5 billion as of June 30, 2015, and contributed \$60.0 million to UW-Madison during the fiscal year ended June 30, 2015. Because WARF's benefit is broader than to just UW-Madison, UW System Administration has determined that, under GASB standards, WARF's financial statements need not be presented as part of UW System's financial statements. However, Note 11 of UW System's *2015 Annual Financial Report* provides further information on the Wisconsin Institutes for Discovery.

The UW Medical Foundation is the clinical practice organization for the faculty physicians of the UW-Madison School of Medicine and Public Health. The UW Medical Foundation provides clinical sites, technical and professional staff, and administrative services. According to its most recent publicly available IRS Form 990, the UW Medical Foundation had net assets of \$314.4 million as of June 30, 2014, and contributed \$32.2 million to UW-Madison

during the fiscal year ended June 30, 2014. Because UW System Administration has decided that the UW Medical Foundation is not financially significant to UW System, the UW Medical Foundation's financial statements are not presented as part of UW System's financial statements. However, Note 11 of UW System's *2015 Annual Financial Report* discloses certain payments UW Medical Foundation made to UW-Madison. In June 2015, the Board of Regents approved an agreement between the UW Medical Foundation and the UW Hospital and Clinics Authority, which would merge them into one organization.

FY 2015-16 Budget Considerations

Act 55 included a \$150.0 million base budget reduction in each year of the biennium in GPR and provided \$25.0 million in GPR each year to offset the reduction.

As noted, UW System's second-largest revenue in FY 2014-15 was State Appropriations, which includes all GPR received by UW System, except for GPR appropriated for debt service payments. In 2015 Wisconsin Act 55, the 2015-17 Biennial Budget Act, GPR appropriated to UW System for general program operations, which include the salaries, fringe benefits, utilities, and supplies and services used to provide an education to students enrolled at UW institutions, was reduced from FY 2014-15 base year levels. Most significantly, Act 55 included a \$150.0 million base budget reduction in each year of the biennium in GPR for general program operations and provided \$25.0 million in GPR in each year of the biennium to offset the reduction. Nonstatutory language in Act 55 specified that the GPR offset be provided to institutions most affected by the base budget reduction in GPR.

Through UW System's annual operating budget, each institution is allocated a portion of the GPR appropriated to UW System. In preparing its FY 2015-16 annual operating budget, UW System Administration apportioned the \$150.0 million base budget reduction in GPR to each institution based on the institution's proportionate share of UW System's general program operations budget. In addition, UW System Administration apportioned \$12.5 million of the \$25.0 million GPR offset to each institution using the same methodology. The remaining \$12.5 million was apportioned to the institutions based on various factors, such as the number of enrolled Pell grant recipients, faculty compensation levels, enrollment, and the discretion of the UW System President. Appendix 2 is a summary of how these factors were considered for each UW institution. As shown in Table 3, the net reduction resulting from these provisions of Act 55 ranged from \$53.0 million at UW-Madison to \$605,100 at UW-Superior.

Table 3

GPR Base Budget Reduction, by Institution¹
FY 2015-16

Institution	2014-15 Adjusted Base	Percentage of Total	GPR Reduction	GPR Offset	Net Reduction
Madison	\$ 673,525,300	38.0%	\$ (56,985,000)	\$ 4,000,000	\$ (52,985,000)
Milwaukee	241,511,200	13.6	(20,430,000)	4,508,800	(15,921,200)
Eau Claire	92,627,100	5.2	(7,830,000)	939,600	(6,890,400)
Oshkosh	89,587,700	5.0	(7,575,000)	945,700	(6,629,300)
La Crosse	74,988,600	4.2	(6,345,000)	768,800	(5,576,200)
Whitewater	75,847,900	4.3	(6,420,000)	1,277,300	(5,142,700)
Stevens Point	75,864,600	4.3	(6,420,000)	1,327,900	(5,092,100)
Stout	70,006,100	4.0	(5,925,000)	1,216,800	(4,708,200)
Extension	64,834,800	3.7	(5,490,000)	872,000	(4,618,000)
Colleges	68,978,400	3.9	(5,835,000)	1,481,800	(4,353,200)
Platteville	50,677,100	2.9	(4,290,000)	1,207,300	(3,082,700)
River Falls	50,353,200	2.8	(4,260,000)	1,390,700	(2,869,300)
Green Bay	44,604,700	2.5	(3,780,000)	1,354,000	(2,426,000)
Systemwide ²	22,356,000	1.3	(1,890,000)	–	(1,890,000)
Parkside	41,494,900	2.3	(3,510,000)	1,944,400	(1,565,600)
System Administration	7,584,700	0.4	(645,000)	–	(645,000)
Superior	28,020,200	1.6	(2,370,000)	1,764,900	(605,100)
Total	\$1,772,862,500	100.0%	\$(150,000,000)	\$25,000,000	\$(125,000,000)

¹ As affected by UW System Administration's implementation of certain provisions of 2015 Wisconsin Act 55 and excludes GPR appropriated to UW System for debt service payments.

² Accounts maintained by UW System Administration for the benefit of all institutions.

In FY 2015-16, UW System Administration distributed \$20.0 million to UW institutions to slow the effects of the base budget reduction.

Because this was an audit of FY 2014-15, and because our fieldwork concluded in the first half of FY 2015-16, we could not assess UW System's response to the base budget reduction for FY 2015-16. UW System reported taking a number of actions in FY 2015-16 in response to the base budget reduction in GPR. For example, UW System Administration distributed \$20.0 million from its UW Systemwide program revenue balance to UW institutions to slow the effects of the base budget reduction. As shown in Table 4, UW-Milwaukee received \$5.8 million of this distribution, which was the largest amount received by an institution. UW-Superior received \$2.5 million, which was the second-largest amount of the distribution.

Table 4

Program Revenue Balance Distribution by UW System Administration to Institutions¹

Institution	Distribution	Percentage of Total
Milwaukee	\$ 5,825,100	29.1%
Superior	2,501,000	12.5
Madison	1,701,500	8.5
Parkside	1,701,400	8.5
Platteville	1,584,000	7.9
Stout	1,550,000	7.8
River Falls	1,481,500	7.4
Green Bay	1,045,400	5.2
Colleges	839,300	4.2
Eau Claire	439,300	2.2
Stevens Point	331,500	1.7
La Crosse	250,000	1.3
Oshkosh	250,000	1.3
Whitewater	250,000	1.3
Extension	250,000	1.3
System Administration	–	–
Systemwide ²	–	–
Total	\$20,000,000	100.0%

¹ Amounts distributed from UW System Administration's Systemwide program revenue balance.

² Accounts maintained by UW System Administration for the benefit of all institutions.

In addition, UW-Madison implemented a four-year tuition plan, which increased tuition for nonresident undergraduate and certain graduate students. Some institutions have also made changes, such as eliminating vacant positions or laying off employees. For example, UW Colleges consolidated leadership and administrative management functions of its 13 two-year campuses into four regions. At the time of the September 2015 Board of Regents meeting, UW Colleges estimated that this consolidation would result in the elimination of 83 full-time positions.



Program Revenue Balances Reporting ■

In October 2014, the Board of Regents approved its first program revenue balances report, as required by Board of Regents policy. This report, which was for FY 2013-14, was intended to increase transparency and improve the monitoring and oversight of program revenue balances by the Board of Regents, UW System Administration, and UW institutions. In report 15-1, we reviewed the FY 2013-14 program revenue balances report and made recommendations to improve the accuracy and usefulness of the report. To assess whether the recommendations we made in report 15-1 were implemented, we performed a limited review of the FY 2014-15 program revenue balances report, which was published in October 2015, and institution reserves policies. Although UW System Administration implemented our recommendations to improve its report, we again identified concerns with institution reserves policies.

Program Revenue Balances Policy

UW System's total program revenue balance was \$1.2 billion as of June 30, 2015.

UW System receives program revenue from sources such as tuition; auxiliary operations, which include fees charged for student housing and food service; federal revenue; and gifts. On a budgetary basis, and as shown in Table 5, UW System's total program revenue balance increased from June 30, 2005, through June 30, 2013, when it reached nearly \$1.3 billion. The total program revenue balance then decreased by 7.2 percent and was approximately \$1.2 billion as of June 30, 2015.

Table 5

UW System Total Program Revenue Balance¹
 As of June 30
 (in millions)

Year	Total	Percentage Change
2005	\$ 268.2	–
2006	315.2	17.5%
2007	406.0	28.8
2008	443.6	9.3
2009	563.7	27.1
2010	649.6	15.2
2011	836.8	28.8
2012	1,045.0	24.9
2013	1,273.5	21.9
2014	1,185.6	(6.9)
2015	1,182.4	(0.3)

¹ On a budgetary basis.

There is no ongoing statutory requirement for UW System to report to the Legislature on program revenue balances.

In response to concerns regarding program revenue balances held by UW System, 2013 Wisconsin Act 20 required the Board of Regents to propose a methodology for the calculation of program revenue balances and reserves to be approved by the Joint Legislative Audit Committee. In addition, the Board of Regents was required to propose limits on the program revenue balances and reporting on the limits to be approved by the Joint Committee on Finance. A final combined policy was approved in spring 2014. Although 2013 Wisconsin Act 20 required the Board of Regents to develop this policy, there is no ongoing statutory requirement for UW System to report to the Legislature on program revenue balances.

During the Board’s October meeting, UW System Administration now reports to the Board of Regents the fiscal year-end balances for each UW institution for five program revenue sources that do not have a restriction on their use (unrestricted), including tuition, auxiliary operations, general operations, federal indirect cost reimbursement, and other unrestricted program revenue sources, and for four restricted program revenue sources, including gifts, nonfederal grants and contracts, and federal grants and contracts.

UW institutions are required to prepare a detailed spending plan for certain unrestricted program revenue balances that exceed 12.0 percent of expenditures.

For the five unrestricted program revenue sources, the policy also requires each UW institution to categorize its balances using the level-of-commitment categories we defined in report 13-17, and which are included as Appendix 3. In addition, the policy requires the institutions to complete additional reporting, such as detailed spending plans when the ratio of the balance to total expenditures exceeds 12.0 percent. Further, for the tuition and auxiliary operations funds, if the balance is negative, the policy requires the institution to create a savings plan detailing the steps the institution plans to take to eliminate the negative balances. The additional reporting requirements are described in more detail in Appendix 4.

Staff at each UW institution are responsible for preparing the sections of the report that relate to that institution using guidance provided by UW System Administration staff, who facilitate overall preparation of the report. UW System Administration staff indicated that the program revenue balances report is now used for various purposes. For example, UW institutions now use the report to monitor program revenue balances and to understand which schools or subunits within the institution are holding balances and for what purposes. The report is also used by the Board of Regents and UW System Administration to monitor institution balances and when developing annual budgets.

FY 2014-15 Program Revenue Balances Report

As of June 30, 2015, unrestricted program revenue balances for all UW institutions were \$923.9 million, or \$49.4 million less than the balances as of June 30, 2014.

UW System's *Report on Program Revenue Balances by Institution and Level of Commitment* (program revenue balances report) for FY 2014-15 was approved by the Board of Regents during the Board's October 2015 meeting. As shown in Table 6, unrestricted program revenue balances decreased from \$973.3 million as of June 30, 2014, to \$923.9 million as of June 30, 2015, or by \$49.4 million. Unrestricted program revenue balances decreased at 10 of the 17 institutions, with the largest decrease occurring at UW-Milwaukee. UW Systemwide accounts, which are accounts maintained by UW System Administration for the benefit of all UW institutions, increased by \$12.4 million from June 30, 2014, to June 30, 2015, and had the second-largest unrestricted program revenue balance at \$105.3 million. According to UW System Administration, this increase is primarily due to an unanticipated decrease in expenditures paid through UW Systemwide accounts.

Table 6

Unrestricted Program Revenue Balances, by Institution^{1, 2}
As of June 30³
(in millions)

Institution	2015	2014	Difference
Systemwide ⁴	\$105.3	\$ 92.9	\$12.4
Superior	2.0	(1.9)	3.9
Platteville	25.6	22.7	2.9
River Falls	22.2	19.7	2.5
Stout	14.1	11.9	2.2
Parkside	10.8	9.1	1.7
Colleges	25.7	25.5	0.2
Extension	26.0	27.1	(1.1)
Green Bay	20.6	22.2	(1.6)
System Administration	8.7	11.7	(3.0)
Whitewater	41.7	45.6	(3.9)
Oshkosh	43.6	49.7	(6.1)
Stevens Point	33.5	39.9	(6.4)
Madison	377.3	386.5	(9.2)
Eau Claire	39.2	50.3	(11.1)
La Crosse	62.5	76.2	(13.7)
Milwaukee	65.1	84.2	(19.1)
Total	\$923.9	\$973.3	\$(49.4)

¹ On a budgetary basis.

² Includes balances from tuition, including academic student fees and UW-Extension student fees; auxiliary operations; general operations; federal indirect cost reimbursement; and other unrestricted program revenue.

³ As adjusted by allocations to UW institutions from UW Systemwide accounts.

⁴ Accounts maintained by UW System Administration for the benefit of all UW institutions.

UW-Superior's program revenue balance increased by \$3.9 million from negative \$1.9 million as of June 30, 2014, to \$2.0 million as of June 30, 2015. According to the program revenue balances report, UW-Superior's savings plan, this increase is primarily due to a reduction in the deficit in its auxiliary operations fund, which resulted from higher room occupancies in student housing and the implementation of personnel cost saving measures in FY 2014-15. Appendix 5 is a summary of unrestricted program revenue balances by institution and by level of commitment as reported by UW System Administration in the FY 2014-15 and the FY 2013-14 program revenue balances reports.

All UW institutions were required to submit a detailed spending plan for at least one unrestricted program revenue source.

As shown in Table 7, for both the FY 2013-14 and FY 2014-15 program revenue balances reports, each UW institution was required to submit a detailed plan on how funds will be spent for at least one of its four unrestricted program revenue sources. However, only 8 institutions were required to submit detailed spending plans for tuition balances in FY 2014-15, compared to 13 institutions as reported in the FY 2013-14 program revenue balance report.

Table 7

Ratio of Unrestricted Program Revenue Balances to Expenditures
As of June 30, 2015

Institution	Savings Plan Required ¹		Spending Plan Required ²		General Operations		Other Unrestricted Program Revenue	
	Tuition ³		Auxiliary Operations		General Operations		Other Unrestricted Program Revenue	
	2014	2015 ⁴	2014	2015 ⁴	2014	2015 ⁴	2014	2015 ⁴
Colleges	23.3%	22.7%	36.2%	49.7%	78.6%	72.2%	10.7%	22.4%
Eau Claire	15.2	8.6	52.3	45.8	92.4	76.9	87.1	88.5
Extension	14.9	12.9	41.4	40.7	28.4	22.5	709.8	98.9
Green Bay	16.2	15.3	32.8	39.5	136.5	69.4	32.6	38.1
La Crosse	20.9	19.5	80.7	40.6	269.8	127.8	4.0	3.8
Madison	8.1	7.3	30.2	29.0	9.2	9.1	14.3	18.6
Milwaukee	15.1	9.1	13.1	19.0	37.1	32.6	14.3	24.0
Oshkosh	15.3	8.3	47.2	46.9	103.9	107.1	3.0	2.0
Parkside	18.2	21.1	(9.3)	(8.5)	62.2	84.0	5.8	8.0
Platteville	15.5	13.9	7.4	19.9	11.4	9.0	99.3	126.2
River Falls	14.5	11.8	17.8	37.7	23.2	12.6	104.5	104.5
Stevens Point	19.4	11.2	32.4	35.4	38.9	29.6	34.8	30.1
Stout	2.1	6.5	4.5	(1.2)	30.0	37.8	6.7	4.9
Superior	5.8	4.8	(62.7)	(17.2)	24.9	18.4	0.5	(0.3)
System Administration	–	–	140.2	107.8	382.5	308.2	–	–
Systemwide ⁵	298.9	403.0	65.5	78.5	48.3	70.3	–	–
Whitewater	26.6	20.1	15.4	21.6	42.2	36.6	43.8	51.2

¹ Required when the balance in the tuition and auxiliary operations funds is negative.

² Required when the ratio of the balance to total expenditures exceeds 12.0 percent

³ Includes tuition and GPR expenditures, Excludes GPR-funded debt service.

⁴ As reported in UW System's FY 2014-15 Report on Program Revenue Balances by Institution and Level of Commitment.

⁵ Accounts maintained by UW System Administration for the benefit of all UW Institutions.

Three UW institutions had deficits in their auxiliary operations accounts as of June 30, 2015, and were required to submit a savings plan.

Two institutions—UW-Parkside and UW-Superior—were required to submit a savings plan for deficit balances as of June 30, 2014. These institutions continued to have deficits in auxiliary operations accounts as of June 30, 2015, and indicated that their deficit was primarily the result of student housing construction and would take several years to resolve. In addition, UW-Stout was required to submit a savings plan for a deficit in its auxiliary operations accounts as of June 30, 2015. In its savings plan, UW-Stout indicated that several one-time purchases, such as purchase of additional parking and upgrades to student health software, were primarily responsible for the deficit.

During the FY 2013-14 audit, we reviewed the detailed spending plans and tested whether the report met the requirements of the policy. At that time, we identified concerns with the documentation provided to support the categorization of a balance as obligated or planned, the categorization of federal indirect cost reimbursement balances as designated, and the categorization of balances as reserves by some UW institutions. In report 15-1, we recommended that UW System Administration:

- provide guidance to the institutions related to the categorization of federal indirect cost reimbursement balances;
- provide guidance to institutions related to documentation required to support balances categorized as reserves, the definition of reserves, and the relationship between reserves maintained by UW System Administration and those maintained by the institutions;
- include information regarding when an institution's reserves and undocumented balances exceed 12.0 percent of the expenditures from the program revenue source during the fiscal year; and
- consider additional review of the categorization of program revenue balances, including review by UW System's Office of Internal Audit.

We followed up on the steps taken by UW System Administration to address our recommendations from report 15-1, and we performed a limited review of the FY 2014-15 program revenue balances report. We found UW System Administration provided additional guidance to the institutions through the coordination of several teleconference calls with them. In addition, UW System Administration updated

and clarified a frequently asked questions document to assist the institutions in categorizing their balances. This document included guidance on the appropriate categorization of federal indirect cost reimbursement balances and the appropriate level of documentation to support the use of the reserves category.

Although UW System Administration staff provided additional guidance to the institutions, they did not request or review documentation provided by the institutions to support the institutions' categorization of commitments. Staff indicated limited time was available to complete such a review and meet the October reporting deadline. UW System Administration staff indicated that they did question some of the categorizations and sought clarification from the institutions to ensure appropriate categorization.

UW System's Office of Internal Audit is performing a review of the FY 2013-14 and FY 2014-15 program revenue balances reports.

In response to our recommendations, UW System Administration also included additional information in the program revenue balances report when an institution's reserves and undocumented balance exceeded 12.0 percent of the expenditures from the program revenue source. We also note that UW System's Office of Internal Audit is performing a review of the FY 2013-14 and the FY 2014-15 program revenue balances reports. The Office of Internal Audit anticipates fieldwork will end in February 2016 and a report will be published in spring 2016.

Although UW System Administration has taken steps to improve the accuracy and completeness of the program revenue balances report, additional review and guidance is needed related to the reserves policies developed by the institutions to support categorizing balances as reserves.

Reserves Policies

Reserves are defined as balances for which documentation indicates amounts are purposefully held for contingencies. Examples of contingencies include unexpected declines or fluctuations in enrollment, abrupt termination of federal funding, emergencies, or other unforeseen circumstances. Guidance provided by UW System Administration indicates that balances categorized as reserves should be supported by a memo or policy authorized by the chancellor or other authorized individual that indicates the amount of the reserves or the reserves target and who is authorized to approve the use of the reserves balance.

Of the 15 institutions reporting a balance as reserves, 14 had a reserves policy.

We requested documentation from the UW institutions to determine if the documentation met requirements for categorizing balances as reserves. In the FY 2014-15 program revenue balances report, 14 of the 15 UW institutions reporting a balance as reserves had a reserves policy, but 2 were only in draft form, as shown in Table 8. In comparison, in the FY 2013-14 program revenue balances report, only 7 of the 14 institutions reporting balances as reserves had documentation such as a memo or reserves policy in place.

Table 8

Reserves Policies of UW Institutions
As of December 31, 2015

Institution	Balance Categorized as Reserves	Reserves Policy Available ¹	Policy Includes Only Allowable Uses for Reserves Funds
Colleges	Yes	✓	✓
Eau Claire	Yes	✓	✓
Extension	Yes	✓	✓
Green Bay	Yes	✓ ²	✓
La Crosse	Yes	✓	
Madison	Yes	✓	
Milwaukee	No		n.a. ³
Oshkosh	Yes	✓	✓
Parkside	Yes		n.a. ³
Platteville	Yes	✓	
River Falls	Yes	✓	✓
Stevens Point	Yes	✓	
Stout	Yes	✓ ²	✓
Superior	Yes	✓	✓
System Administration ⁴	Yes	✓	✓
Whitewater	Yes	✓	✓

¹ Reserves policy or memo available to support categorization of balances as reserves.

² Reserves policy was in draft status at the time of our fieldwork in December 2015.

³ Not applicable because the institution did not prepare a reserves policy.

⁴ UW System Administration and Systemwide were considered one unit when assessing the reserves policies.

For those institutions that had reserves policies, we found the definition of reserves included in the policies for four institutions—UW-La Crosse, UW-Madison, UW-Platteville, and UW-Stevens Point—conflicted with the definition in the Board of Regents policy or guidance provided by UW System Administration. For example, some policies allowed funds to be set aside for strategic opportunities or the policies stated reserves goals but did not define allowable uses of reserve funds. In addition, we found the reserves policies for seven institutions did not indicate who may authorize the use of reserves.

UW System Administration staff did not review the reserves policies from the institutions during the compilation of the program revenue balances report.

Without complete documentation, the Board of Regents and UW System Administration cannot be assured that balances are being categorized as reserves in a consistent manner by all UW institutions. UW System Administration staff did not review the reserves policies from the institutions during the compilation of the program revenue balances report. Therefore, UW System Administration was unable to assess the appropriateness of categorizing balances as reserves, to ensure compliance with UW System Administration guidance or Board of Regents policies, or to address any potential concerns of institution reserves purposes overlapping with UW System Administration reserves purposes. Such a review of institutional reserves policies may enable the institutions to update and improve their reserves policies as needed prior to preparation of the FY 2015-16 program revenue balances report.

Recommendation

We recommend the University of Wisconsin System Administration:

- *review the current University of Wisconsin institution reserves policies to ensure the policies are complete and consistently in compliance with Board of Regents policies and University of Wisconsin System Administration guidance; and*
- *report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement this recommendation.*

■ ■ ■ ■

Investments ■

***As of June 30, 2015,
UW System held
\$523.4 million in
investments related
to gifts, grants,
and bequests.***

Donors may make gifts, grants, or bequests to the Board of Regents or to an individual UW institution. Under s. 36.29 (1), Wis. Stats., the Board of Regents is responsible for investing all such funds. As of June 30, 2015, UW System held \$523.4 million in such investments, the majority of which was invested by external managers hired by UW System Administration. Most of the funds received were donated to support scholarship programs or specific academic programs or research. UW System Administration indicates that it distributed \$189.9 million in investment earnings for the ten-year period ended June 30, 2014. We reviewed the role of the Board of Regents and the Office of Trust Funds in overseeing the investment of these funds, and we reviewed the investment policies that the Office of Trust Funds uses to manage investments. We make several recommendations to improve oversight and administration of investments.

Funds under Management

***The Office of Trust
Funds manages
investments through the
Long Term Fund and the
Intermediate Term Fund.***

The Office of Trust Funds manages investments through two different funds. The Long Term Fund is used to invest endowed assets for which the principal is to be retained and the earnings on the principal may be expended. The Long Term Fund's objective is to achieve significant real returns, net of administrative and investment expenses. The investments in the Long Term Fund totaled \$386.1 million as of June 30, 2015.

The Intermediate Term Fund is used to invest fully expendable assets, typically for an investment period of three to five years. The

Intermediate Term Fund’s objective is to provide competitive returns consistent with moderate levels of volatility and safety of principal. The investments in the Intermediate Term Fund totaled \$85.3 million as of June 30, 2015.

UW System invests idle cash, such as new gifts awaiting long-term investment and spending distributions from the Long Term Fund, in the State Investment Fund (SIF), which is a short-term pool of state and local government funds managed by the State of Wisconsin Investment Board (SWIB). As of June 30, 2015, UW System held \$52.0 million in investments in the SIF. As we discussed in report 15-19, the primary objective of the SIF is to provide liquidity, safety of principal, and competitive rates of return, similar to a money market fund.

Organizational Structure

The Board of Regents has oversight responsibilities for trust fund investments.

The Board of Regents is the principal fiduciary with oversight responsibilities for investments of the Office of Trust Funds. The Board of Regents has delegated responsibility for oversight of the Office of Trust Funds to its Business and Finance Committee. The Business and Finance Committee recommends to the Board of Regents, for its approval, the annual UW System Trust Funds Investment Policy Statement, which includes the asset allocations and benchmarks for each fund, the spending policy for the Long Term Fund, and proxy voting and social responsibility policies. The Business and Finance Committee also makes recommendations to the Board of Regents for the election of all officers with responsibility for the investments including the Trust Officer and any Assistant Trust Officers. Neither statute nor Board of Regents policy requires any member of the Board of Regents to have investment experience or expertise.

The Office of Trust Funds is responsible for daily management and administration of the trust funds.

The Office of Trust Funds is organized within UW System Administration’s Office of Finance. According to the UW System Trust Funds Investment Policy Statement, the Vice President for Finance, who also holds the position of Trust Officer, “in general oversees the management and administration of the Office of Trust Funds.” The Office of Trust Funds has four positions: the Director of Trust Funds, an investment analyst, an accountant, and a financial specialist. The Director of the Office of Trust Funds, who is also an Assistant Trust Officer, is responsible for daily management and administration of the trust funds. These duties include:

- managing and maintaining records of all trust funds of UW System;

- hiring and terminating external investment managers;
- reporting to the Business and Finance Committee;
- managing and monitoring all external and internal expenses and fees; and
- working with donors, estates, and trusts to properly establish new trust fund accounts.

The Office of Trust Funds is funded by investment earnings and does not receive any GPR. Salaries and fringe benefits for staffing the Office of Trust Funds totaled \$390,350 for FY 2014-15.

Composition of the Long Term and Intermediate Term Funds

The Office of Trust Funds establishes asset allocation plans that apportion investment assets to balance risk and potential returns.

Within the investment goals and objectives for the Long Term Fund and Intermediate Term Fund, the Office of Trust Funds establishes an asset allocation plan, which is an overall strategy to apportion investment assets to balance risk and potential returns for each fund. Through this process, an amount of assets is determined as a target for each asset class. Further, the Office of Trust Funds establishes a range for each asset allocation target to provide flexibility in managing the funds. For example, in the Long Term Fund, the target allocation for Real Assets, which includes investments in commercial real estate, is 15.0 percent, the minimum allocation is 5.0 percent, and the maximum allocation is 25.0 percent. According to the UW System Trust Funds Investment Policy Statement, asset allocation plans for each fund are reviewed and approved annually by the Board of Regents.

Long Term Fund

The overall asset allocation plan for the Long Term Fund, which was approved by the Board of Regents at its December 2015 meeting, allocated investments across five broad categories:

- Global Tactical Asset Allocation, which is an investment strategy that seeks to actively shift allocations among a global set of asset classes based on perceived relative valuations and expected returns of the various asset classes at different points in time;

- Growth and High-Yielding Assets, which are higher risk but higher potential return investments and include investments in emerging market and private market equities, high-yielding corporate debt and emerging market debt, and investment in certain hedge fund strategies;
- Event Risk and Deflation Hedge Assets, which are lower-risk investments and include U.S. Treasury bonds and cash;
- Real and Inflation Hedge Assets, which are assets that help to protect the fund against the effects of inflation and include U.S. Treasury Inflation Protected Securities and investments in real assets, such as commercial real estate; and
- Opportunistic Investments, which is a potential allocation that provides flexibility for the Office of Trust Funds to invest in unique opportunities that may arise, but that do not fit within an existing asset class or within the ranges of an asset class.

The asset allocation plan for the Long Term Fund was last changed in December 2011.

Although the asset allocation plan is reviewed and approved annually by the Board of Regents, the Board of Regents has not changed the Long Term Fund asset allocation plan since December 2011 when the target allocation for High Quality Debt/Credit and High-Yield Debt/Credit was increased and the target allocation for Emerging Market Equities and Real Assets was decreased. As shown in Table 9, the actual investments for the Long Term Fund were within the established asset allocation ranges for all but two asset classes as of June 30, 2015.

Table 9

Asset Allocation for Long Term Fund
As of June 30, 2015

	Minimum Allocation	Target Allocation	Maximum Allocation	Actual Allocation ¹
Global Tactical Asset Allocation	20.0%	25.0%	30.0%	29.3%
Growth and High-Yielding Assets:				
Global Developed Market Equities	15.0	18.0	35.0	30.5
Emerging Market Equities	0.0	5.0	10.0	8.1
Private Equity	5.0	10.0	15.0	12.8
High-Yield Debt/Credit ²	0.0	7.0	15.0	6.5
Directional Hedge Fund Strategies ³	0.0	0.0	15.0	0.0
Event Risk and Deflation Hedge Assets:				
High Quality Debt/Credit ⁴	5.0	10.0	35.0	4.1
U.S. Cash	0.0	0.0	10.0	2.1
Absolute Return Strategies ⁵	0.0	7.0	15.0	0.0
Real and Inflation Hedge Assets:				
U.S. Treasury Inflation Protected Securities	0.0	3.0	10.0	5.0
Real Assets ⁶	5.0	15.0	25.0	1.6
Opportunistic Investments ⁷	0.0	0.0	20.0	0.0
Total		100.0%		100.0%

¹ Actual allocations that are outside the target allocation ranges are in **bold**.

² Includes investments in high-yielding corporate debt or bank loans and emerging market debt.

³ Includes investments in long-biased equity or high-yield/distressed debt strategies.

⁴ The investments in this asset class have been in U.S. Cash since a former portfolio was liquidated in 2006.

⁵ An investment strategy in which the investor seeks to make positive returns despite current market trends by employing investment management techniques that differ from a traditional mutual fund.

⁶ Includes investments in real assets such as private/public commercial real estate, timber and farmland, commodities, and infrastructure.

⁷ This allocation provides the Office of Trust Funds the flexibility to invest in unique opportunities as they arise.

We note that actual allocations for High Quality Debt/Credit and Real Assets have been outside of the target allocation ranges since at least 2011. Although the Office of Trust Funds reports an actual allocation of 4.1 percent to High Quality Debt/Credit, we note that these funds have been invested in U.S. Cash since a former portfolio was liquidated in 2006. This asset class totaled \$15.8 million as of June 30, 2015.

Staff also indicated that they are working to achieve the target allocation percentage for Real Assets. However, staff noted that the process to invest in this asset class is lengthy, and they have yet to

reach the target. Real Assets were added to the asset allocation plan in 2005.

Intermediate Term Fund

The asset allocation plan for the Intermediate Term Fund was last changed in December 2011.

The overall asset allocation plan for the Intermediate Term Fund allocates investments across three broad categories: Growth and High-Yielding Assets, Event Risk and Deflation Hedge Assets, and Real and Inflation Hedge Assets. Although the asset allocation plan is approved annually by the Board of Regents, it has not been changed since December 2011 when the target allocation for High Quality Debt/Credit was increased and the target allocation for U.S. Cash and U.S. Treasury Inflation Protected Securities was decreased. Prior to September 2007, the asset allocation plan for the Intermediate Term Fund required 100.0 percent of the assets to be invested in fixed income securities. As shown in Table 10, the actual investments for the Intermediate Term Fund were within the established asset allocation ranges for all but one asset class as of June 30, 2015.

Table 10

Asset Allocation for the Intermediate Term Fund June 30, 2015

	Minimum Allocation	Target Allocation	Maximum Allocation	Actual Allocation ¹
Growth and High-Yielding Assets:				
Global Developed Market Equities	5.0%	15.0%	20.0%	14.4%
Emerging Market Equities	0.0	0.0	5.0	0.0
High-Yield Debt/Credit ²	0.0	5.0	10.0	5.7
Event Risk and Deflation Hedge Assets:				
High Quality Debt/Credit ³	40.0	50.0	75.0	67.1
U.S. Cash	0.0	5.0	15.0	2.1
Absolute Return Strategies ⁴	5.0	10.0	15.0	0.0
Real and Inflation Hedge Assets:				
U.S. Treasury Inflation Protected Securities	5.0	15.0	30.0	10.7
Total		100.0%		100.0%

¹ Actual allocations that are outside the target allocation ranges are in **bold**.

² Includes investments in high-yielding corporate debt or bank loans and emerging market debt.

³ Includes investments in U.S. Treasuries.

⁴ An investment strategy in which the investor seeks to make positive returns despite current market trends by employing investment management techniques that differ from a traditional mutual fund.

The Office of Trust Funds did not identify opportunities to invest in Absolute Return Strategies.

The actual allocation for the Absolute Return Strategies, which is an investment strategy in which the investor seeks to make positive returns despite current market trends by employing investment management techniques that differ from a traditional mutual fund, has been at zero since it was first established in 2007. The Office of Trust Funds indicated that it did not identify opportunities to invest in this asset class.

Although there may be challenges to investing in certain asset classes, the Office of Trust Funds is not in compliance with the approved asset allocation plans for the trust funds.

Recommendation

We recommend the University of Wisconsin System Administration:

- *review the asset allocation plans, particularly for the asset classes that are outside the approved ranges, to determine if changes should be made to the asset allocation plans;*
- *report to the Board of Regents on the results of the review, and seek approval of any revisions to the asset allocation plans; and*
- *report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations.*

Administration of the Trust Funds

Approximately 82.0 percent of the trust fund assets in the Long Term and Intermediate Term funds are managed by external investment managers.

The Office of Trust Funds contracts with external investment managers to invest the majority of the trust fund assets. Approximately 82.0 percent of the assets in the Long Term and Intermediate Term funds are managed by external managers, and 8.0 percent of the assets are invested in indexes or exchange-traded funds by Office of Trust Funds staff. The remaining 10.0 percent of assets are managed by students in the Applied Securities course at UW-Madison.

The Director of the Office of Trust Funds has responsibility for hiring and terminating external investment managers, with a 15-day notice provided to the Business and Finance Committee. Based on the UW System Trust Funds Investment Policy Statement, the Director of the Office of Trust Funds is to provide a due diligence memo regarding each prospective hire or termination. If any Committee member has a concern, the decision will be delayed

pending further due diligence. The hiring of external investment managers is required to follow an appropriate procurement and selection process that complies with UW System and state procurement policies and practices. No new external investment managers have been hired since 2006. The last time an external investment manager was terminated was 2012.

Monitoring of External Investment Managers

Ongoing due diligence monitoring of external investment managers is the responsibility of the Office of Trust Funds.

The Director of the Office of Trust Funds is responsible for the oversight of all external investment managers. According to the UW System Trust Funds Investment Policy Statement, ongoing due diligence monitoring includes, at a minimum:

- annual in-depth meetings with key investment and/or firm representatives;
- in-depth meetings at the offices of the investment managers every two to three years;
- attendance at client conferences and educational forums when available; and
- open telephone or electronic communication with key personnel as needed.

The Office of Trust Funds did not complete an annual due diligence meeting for two of the six external investment managers in 2015.

Based on the documentation we reviewed, we found that due diligence meetings were held for all external investment managers in 2013 and 2014. However, we also found the Office of Trust Funds did not complete an annual due diligence meeting for two of the six external investment managers in 2015, and a due diligence meeting was not held in 2012 for another external investment manager. Further, we note that documentation was not always available to support the ongoing due diligence that the Office of Trust Funds indicates was performed. For example, staff were unable to provide written reports or notes for 7 of the 10 meetings staff indicated were held in 2011 and 2012.

Under the Investment Policy Statement, the Business and Finance Committee of the Board of Regents requires the Office of Trust Funds to prepare, for each external investment manager, an “annual investment manager due diligence report” (annual due diligence report), which summarizes the most recent annual due diligence meetings held with that external investment manager and to highlight any areas of concern. We found that the Office of Trust Funds completed an annual due diligence report for only one of the six external investment managers in 2015. The report was filed with

the Business and Finance Committee in January 2015. We also note that an annual due diligence report was completed for only four of the six external investment managers in 2014, and for five of the six external investment managers in 2013.

Appendix 6 lists the six external investment managers, including the portfolios managed by each and the market value of the assets managed in each portfolio.

Turnover in the Office of Trust Funds may have contributed to a decrease in the number of regular meetings with the external investment managers during 2015 and to delays in reporting to the Board of Regents. However, ongoing due diligence by the Office of Trust Funds is important to ensure the external investment managers are managing the investments appropriately to meet investment goals and objectives. Further, the Board of Regents cannot meet its fiduciary responsibilities related to the investments if an annual due diligence report is not completed for each external investment manager and provided to the Business and Finance Committee.

Recommendation

We recommend the University of Wisconsin System Administration:

- *make improvements to its current processes to ensure that ongoing due diligence is being completed and documented in accordance with the University of Wisconsin System Trust Funds Investment Policy Statement;*
- *complete and provide an annual due diligence report for each external investment manager to the Board of Regents Business and Finance Committee, as required by the University of Wisconsin System Trust Funds Investment Policy Statement; and*
- *report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations.*

External Investment Management Fees

The Office of Trust Funds pays investment management fees to external investment managers to manage the assets.

The Office of Trust Funds is responsible for monitoring and managing expenses related to the administration and management of the trust funds. These expenses include the salaries and fringe benefits of Office of Trust Funds staff, as well as investment management fees paid to external investment managers. We evaluated the expenses of the Office of Trust Funds and identified concerns with monitoring of external investment management fees.

The fees that external investment managers charge for managing the investments are outlined in the terms of UW System Administration's contract with each external investment manager. External investment managers can either bill the Office of Trust Funds for external investment management fees or charge the fees against the investment earnings of the portfolio. Of the nine portfolios managed by an external investment manager, external investment management fees are charged against the investment earnings for five portfolios and directly billed to the Office of Trust Funds on a quarterly basis for four portfolios. Fees are not charged for the investments managed by the students in the Applied Securities course at UW-Madison.

It is common practice in the investment industry for external investment managers to charge the investment management fees against the investment earnings of the portfolio, and to report net investment earnings for the portfolio. However, it would be anticipated that the Office of Trust Funds would request information on actual investment management fees charged against investment earnings to ensure such fees comply with the terms of the contracts with the external investment managers. We note that SWIB requests and receives information on a monthly basis from its external investment managers regarding the actual investment management fees paid and performs an evaluation to ensure compliance with the terms of the external investment manager contracts.

The Office of Trust Funds does not ensure external investment management fees are charged against earnings in accordance with the terms of the contracts.

We found the Office of Trust Funds does not request information from the external investment managers regarding the actual fees charged against earnings. Instead, staff annually estimate the amount of investment management fees paid to those external investment managers. The Director of the Office of Trust Funds noted that external investment management fees that are billed to the Office of Trust Funds are compared to the external investment manager contracts.

As shown in Table 11, external investment management fees increased from \$2.7 million in FY 2010-11 to \$3.1 million in FY 2014-15, or by 15.4 percent. Internal operating expenses of the Office of Trust Funds have been consistent over the past five years, with a small decline overall. The increase in internal operating expenses in FY 2013-14 was the result of the implementation of a new investment accounting system. UW System contracted with Huron Consulting to implement this new system.

Table 11

Office of Trust Funds Expenses¹
 FY 2010-11 through FY 2014-15

	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15
External Investment Management Fees:					
Directly Billed	\$1,159,600	\$1,188,898	\$1,235,614	\$1,271,155	\$1,362,390
Charged Against Earnings ²	1,509,644	1,514,676	1,548,251	1,600,605	1,717,282
Subtotal	2,669,244	2,703,574	2,783,865	2,871,760	3,079,672
Internal Operating Expenses:					
Salaries and Fringe Benefits	391,680	386,715	389,900	402,150	390,350
Accounting and Custodian Fees	42,254	42,879	46,891	49,343	16,800
Professional Services	-	-	-	196,652	-
Administrative Costs	16,975	14,818	24,256	2,650	9,670
Management Consulting	1,120	2,124	1,559	1,702	2,200
Subtotal	452,029	446,536	462,606	652,497	419,020
Total	\$3,121,273	\$3,150,110	\$3,246,471	\$3,524,257	\$3,498,692

¹ As presented in the annual trust funds report to the Board of Regents, except for FY 2014-15.

² Estimated by the Office of Trust Funds.

Without adequate oversight of the external investment management fees paid, UW System may be paying more than required, which would decrease the amount of investment earnings that could be used for the purposes originally intended by the donors.

☑ Recommendation

We recommend the University of Wisconsin System Administration improve its monitoring of external investment management fees by:

- *requesting from each external investment manager, on at least an annual basis, information on the actual investment management fees charged against investment earnings;*
- *comparing the amount of investment management fees charged against investment earnings to the terms of the contracts with the external investment managers to ensure the University of Wisconsin System is paying the correct amount of fees; and*
- *reporting the results of this review to the Board of Regents on an annual basis.*

In addition, we recommend the University of Wisconsin System Administration report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations.

Investment Performance

Performance returns for four of the nine portfolios managed by external investment managers lagged benchmarks.

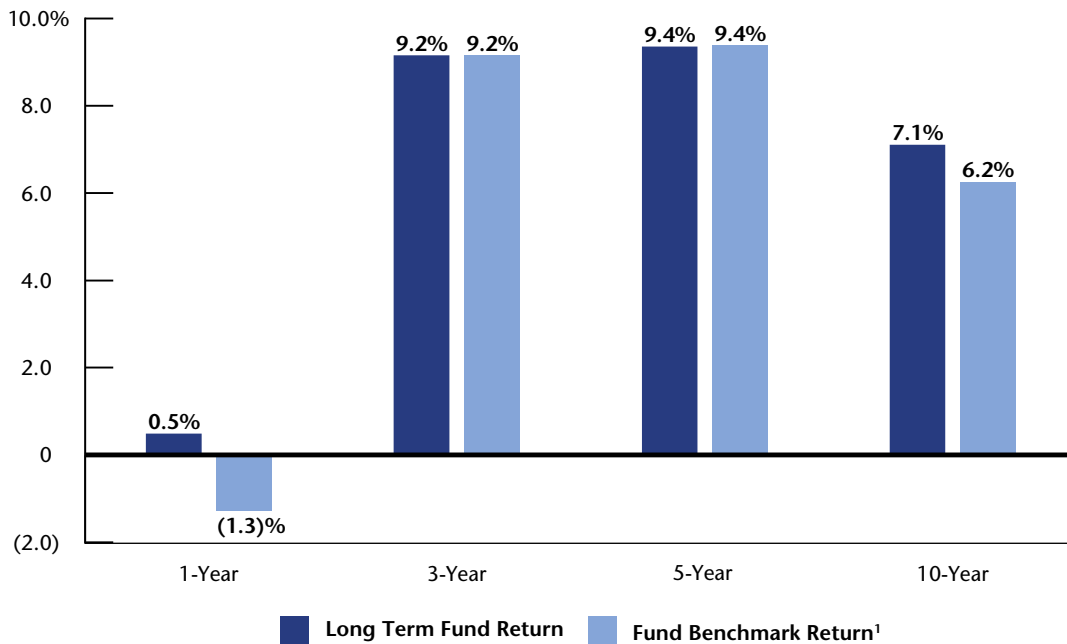
External investment managers are expected to manage each portfolio in accordance with the portfolio's individualized investment guidelines and, according to the UW System Trust Funds Investment Policy Statement, seek to outperform the assigned benchmarks. External investment managers are required to provide portfolio holdings and valuations, a transactions summary, and investment returns for the most recent period and since inception of the portfolio to the Office of Trust Funds on at least a quarterly basis. The Office of Trust Funds establishes a benchmark to assess the overall strategies for the Long Term Fund and Intermediate Term Fund investments. In addition, the Office of Trust Funds uses different benchmarks to measure and evaluate the performance of each of the external investment managers. Appendix 6 includes a summary of investment performance by each external investment manager for the period ended June 30, 2015. We note that performance returns for four of the nine portfolios managed by external investment managers lagged benchmark returns for most periods reported.

The Long Term Fund returns met the benchmark returns as of June 30, 2015.

We reviewed investment performance for the Long Term Fund and the Intermediate Term Fund for the period ended June 30, 2015. As shown in Figure 4, the investment performance of the Long Term Fund met the established benchmarks for each period.

Figure 4

**Investment Performance of the Long Term Fund
As of June 30, 2015**

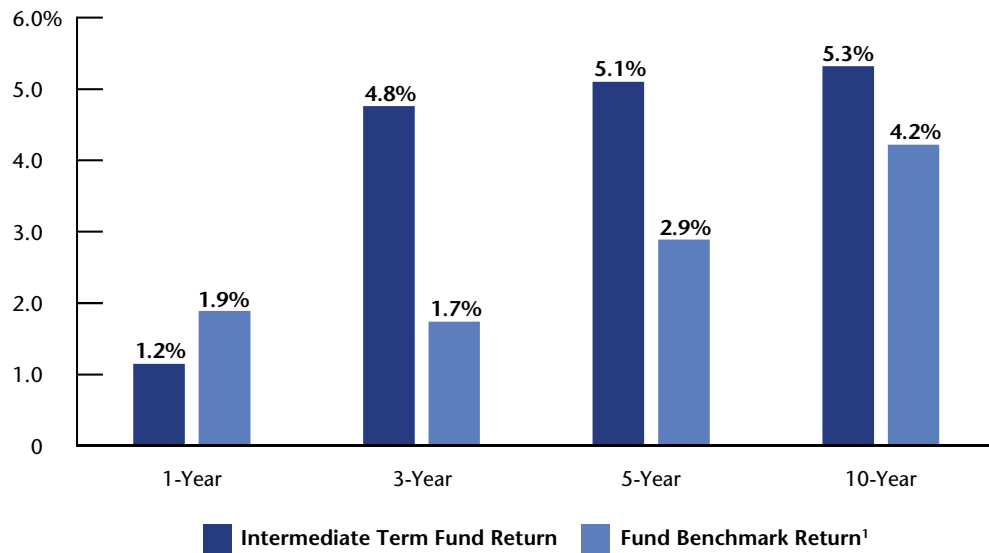


¹ The benchmark is representative of a typical globally diversified portfolio, which would include both developed and emerging markets.

Performance of the Intermediate Term Fund lagged the established one-year benchmark returns, but met the established benchmark returns for the remaining periods presented, as shown in Figure 5.

Figure 5

Investment Performance of the Intermediate Term Fund
As of June 30, 2015



¹ The benchmark is the Barclay's Intermediate Aggregate Index Fund, which represents a more traditional intermediate expendables fund.

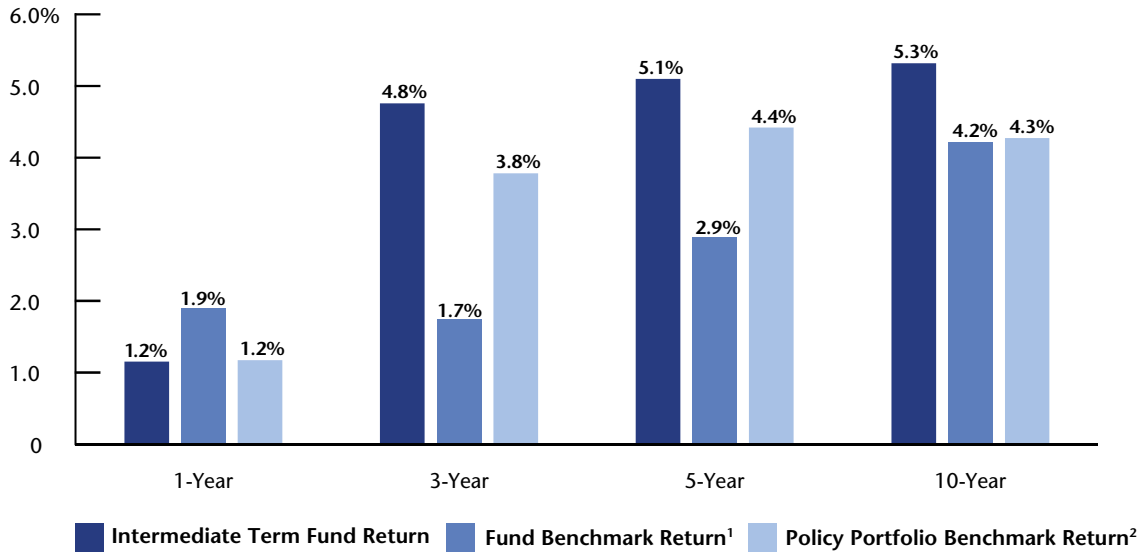
The Office of Trust Funds uses Barclay's Intermediate Aggregate Fund as the benchmark for the Intermediate Term Fund. According to Office of Trust Funds staff, this benchmark is representative of a more traditional, intermediate expendables fund, which consists primarily of investments in fixed income securities that are not actively managed by an investment manager, but rather are passively managed with the goal of mirroring a market index.

According to the UW System Trust Funds Investment Policy Statement, once the Intermediate Term Fund achieves asset allocations close to the target asset allocations, the policy portfolio benchmark is to be used. This benchmark is described in the policy as a benchmark comprised of several different benchmarks that relate to each asset class in the Intermediate Term Fund, each weighted to match the asset allocation plan. The Intermediate Term Fund is close to its target asset allocations. Therefore, we compared the performance of the Intermediate Term Fund to the policy portfolio benchmark. As shown in Figure 6, performance of the Intermediate Term Fund exceeded the three-year, five-year, and ten-year returns of this benchmark. However, the policy portfolio benchmark outperformed the Barclay's Intermediate Aggregate Fund Benchmark in the three-year, five-year, and ten-year periods,

an indication that it may be a better benchmark to assess overall performance of the Intermediate Term Fund.

Figure 6

Intermediate Term Fund Investment Performance Compared to Benchmarks
As of June 30, 2015



¹ This benchmark is the Barclay’s Intermediate Aggregate Index Fund, which represents a more traditional intermediate expendables fund.

² This benchmark is comprised of several different benchmarks that relate to each asset class in the Intermediate Term Fund, each weighted to match the asset allocation plan.

It is an appropriate time for the Board of Regents to reassess the benchmark used for the Intermediate Term Fund.

In order to accurately assess how well the Fund is performing, it is important to compare investment performance against benchmarks that match the risks and returns of the investments in the Intermediate Term Fund. Given the Intermediate Term Fund is close to its asset allocation targets, it is an appropriate time to reassess whether the policy portfolio benchmark should be used to assess the performance of the Intermediate Term Fund as well as used in future reporting to the Board of Regents. Alternatively, the Board of Regents could consider whether a different benchmark is more appropriate for the Intermediate Term Fund.

☑ Recommendation

We recommend the University of Wisconsin System Administration:

- *review the benchmarks used to assess and report on investment performance of the Intermediate Term Fund and determine if an alternative benchmark should be used;*
- *report to the Board of Regents on the results of the benchmark review and propose any changes to be made regarding assessing investment performance of the Intermediate Term Fund; and*
- *report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations.*

Reports to the Board of Regents

Several reporting mechanisms have been put in place to assist the Board of Regents in meeting its fiduciary responsibilities.

In its role as the principal fiduciary of the gifts, grants, and bequests managed by the Office of Trust Funds, the Board of Regents is responsible for overseeing the Office of Trust Funds and ensuring the assets are invested prudently to maximize investment returns. There are several mechanisms in place to provide information to the Board of Regents to assist it in meeting its fiduciary responsibilities. For example, the Director of the Office of Trust Funds, or other designees from the Office typically present to the Business and Finance Committee three times each year:

- In February, the Director of the Office of Trust Funds presents the annual trust funds report, which provides an overview of the market value of the investments for the fund and for each external investment manager, a summary of performance in comparison to the benchmarks for the Long Term Fund and Intermediate Term Fund, and a summary of the current asset allocation.
- Typically in March or April, the Director of the Office of Trust Funds provides a summary of a National Association of College and University Business Officers (NACUBO) benchmarking report, which provides comparisons against other endowments on spending policies and practices, investment performance and fees, staffing, and other measures based on peer surveys. This report enables the Board of Regents to compare the Office of Trust Funds policies and fund performance to similar entities in order to identify options for improvement.

- In December, the Director of the Office of Trust Funds presents the UW System Trust Funds Investment Policy Statement, which provides the Committee an opportunity to discuss the policies and procedures within which the assets are to be invested, including an opportunity to reassess the overall asset allocation plans for the Long Term and Intermediate Term funds, as well as the benchmarks that are used to assess performance.

The Office of Trust Funds also emails the Business and Finance Committee members a link to its website where the members can obtain quarterly and monthly performance reports. However, we note that as of February 1, 2016, the most recent information available on its website was as of June 30, 2015.

Additional reporting could assist the Business and Finance Committee in its fiduciary role.

To assist the Business and Finance Committee in its oversight role, the Office of Trust Funds should ensure up-to-date information is available on its website. In addition, it may be helpful for the Director of the Office of Trust Funds to include additional information in the board meeting materials. For example, providing a comparison between the actual asset allocations of the Long Term and Intermediate Term funds to the approved target allocations and ranges would make it easier to identify instances in which the target allocations are not being met. In addition, information on the investment performance of the external investment managers in comparison to benchmarks would allow the Business and Finance Committee to more readily ask questions and discuss performance at the external manager level.

Recommendation

We recommend the University of Wisconsin System Administration improve its reports to the Board of Regents, including by:

- *ensuring information is available on the Office of Trust Funds website in a timely manner;*
- *providing external investment manager performance information in the Board of Regents meeting materials; and*
- *providing a comparison between actual asset allocations of each fund to the approved target allocations and ranges in the Board of Regents meeting materials.*

We further recommend the University of Wisconsin System Administration report to the Joint Legislative Audit Committee by July 29, 2016, on the status of its efforts to implement these recommendations.

Auditor's Report ■



Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters

Senator Robert Cowles and
Representative Samantha Kerkman, Co-chairpersons
Joint Legislative Audit Committee

Members of the University of Wisconsin Board of Regents, and
Dr. Raymond Cross, President
University of Wisconsin System

We have audited the financial statements and the related notes of the University of Wisconsin (UW) System as of and for the years ended June 30, 2015, and June 30, 2014, and have issued our report thereon dated December 17, 2015. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, which is issued by the Comptroller General of the United States. The financial statements and related auditor's opinion have been included in UW System's *2015 Annual Financial Report*.

Internal Control over Financial Reporting

Management of UW System is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audits of the financial statements, we considered UW System's internal control to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of UW System's internal control. Accordingly, we do not express an opinion on the effectiveness of UW System's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent misstatements, or to detect and correct misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement of UW System's financial statements will not be prevented, or that a material misstatement will not be detected and corrected on a timely basis. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, we did not identify

any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in the accompanying finding and response schedule, that we consider to be a significant deficiency.

Because UW System's financial activity is also included in the State of Wisconsin's Comprehensive Annual Financial Report, this significant deficiency is also included in the Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters related to our audit of the State of Wisconsin's financial statements.

In our fiscal year (FY) 2013-14 Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, dated December 12, 2014, we described two internal control deficiencies related to Human Resource System (HRS) security. When combined, these deficiencies were considered to be a material weakness. UW System has taken corrective action to address these internal control deficiencies, such as reviewing and adjusting access and implementing compensating controls.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether UW System's financial statements are free from material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Response to Finding

UW System's written response to the finding identified in our audit is described in the accompanying finding and response schedule. UW System's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of This Report

This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be used when considering UW System's internal control and compliance. The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of UW System's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU



Joe Chrisman
State Auditor

December 17, 2015

FINDING AND RESPONSE SCHEDULE

Finding 2015-001: Information Technology Controls at the University of Wisconsin System

Criteria:

The University of Wisconsin (UW) System consists of 13 four-year universities, 13 two-year colleges, UW-Extension, and UW System Administration. UW System Administration maintains the Shared Financial System (SFS), which is UW System's accounting system, and the Human Resource System (HRS), which is UW System's payroll and personnel system. These systems are used by all UW institutions. In addition, each institution maintains its own student information system (SIS) to administer federal student financial aid programs, as well as other computer applications. To provide proper internal control, information technology (IT) security policies and procedures are necessary to ensure software and data stored and processed by the institutions are protected from accidental or intentional misuse or destruction. In addition, IT controls should be established to prevent inappropriate or inadvertent access to systems and data.

Condition:

We identified weaknesses in IT security policies, procedures, and controls for several computer applications at several UW institutions. We determined that the detailed results of our review were too sensitive to communicate publicly. Therefore, we communicated these results in confidential interim memoranda to the institutions involved.

We did not audit the IT security policies and procedures at all UW institutions or the IT controls over all computer applications used by the institutions. However, we believe there is a potential that similar weaknesses may exist at those institutions we did not review.

Questioned Costs:

None.

Context:

UW institutions operate in a highly computerized environment and are responsible for maintaining confidential and sensitive information, such as student data.

Effect:

Although it can be difficult to determine how IT concerns such as those we identified affect the financial statements and material federal compliance areas, ineffective general IT controls in areas such as these may permit controls over individual systems to operate improperly and may allow financial statement misstatements and noncompliance to occur and not be detected.

Weaknesses in IT security policies, procedures, and controls increase the risk that unauthorized or erroneous transactions could be processed or changes could be made to accounting, payroll, and student data. In addition, failure to provide an appropriate level of protection for UW systems and data increases the risk that personally identifiable information could be accidentally or maliciously exposed.

Cause:

IT staff at each UW institution are responsible for ensuring IT security policies, procedures, and controls are properly developed and maintained. Those institutions that have smaller IT staff

may find challenges in meeting these responsibilities, maintaining proper separation of duties, and monitoring sufficiently all security policies and procedures. In addition, with changing technologies, monitoring and assessment of current processes are necessary to evaluate changing data security risks.

Recommendation:

In addition to recommendations we made to individual UW institutions, we recommend UW System Administration work with the Council of Chief Information Officers, the Chief Business Officers at each institution, and others as appropriate, to assist UW institutions in implementing timely corrective actions related to our institution-specific recommendations, and to develop a UW System-wide information technology security program, including:

- UW System-wide information technology security policies and settings, as appropriate;
- guidance and training to all UW institutions regarding information technology security policies and settings; and
- procedures for assessing the level of protection provided for UW systems and data.

Response from University of Wisconsin System:

In responding to the confidential interim memoranda, the UW institutions involved indicated agreement with the recommendations and provided timelines for implementing corrective actions.

UW System Administration agrees with the recommendation that UW System Administration work with the Chief Information Officers and Chief Business Officers at the institutions to improve IT controls and develop a UW System-wide security program. The recommendation supports the direction in which UW System Administration and the Chief Information Council are working to improve IT security. For example, UW System hired a Chief Security Information Officer in March 2015 to focus on and lead UW System-wide efforts related to IT security.

In addition, the following are some actions UW System Administration is planning to take regarding IT security:

- The UW System Administration Chief Information Officer and Chief Information Security Officer have been developing a UW System-wide or Board of Regents level policy to provide institutions with guidance, standards, and parameters for future decision-making about IT security. The policy will be presented at the February 2016 Board meeting.
- The Chief Information Officers will be holding a visioning session in the near future to consider an overarching IT security strategy.

- The newly instituted Data and Privacy Security Council will also be meeting in the near future. The cross-unit group includes Chief Information Officers and staff from the legal and audit offices at UW System Administration. Further representation is being sought from a wide range of other groups (e.g. student affairs, human resources, etc.). The Council will identify and analyze risks related to IT security and propose and implement solutions that appropriately address these concerns.

Appendices ■

Appendix 1

UW System Affiliated Organizations¹

FY 2014-15²

Alumni Associations

Alumni Association of the University of Wisconsin-Green Bay

UW-Milwaukee Alumni Association, Inc.

UW-Medical Alumni Association, Inc.

UW-La Crosse Alumni Association

UW-Oshkosh Alumni Association, Inc.

UW-Platteville Alumni Association (new)

UW-Superior Alumni Association

The University of Wisconsin-Parkside Alumni Association

Booster Clubs/Friends Organizations

Badger Basketball Boosters, Inc.

Friends of the Geology Museum UW-Madison, Inc.

Friends of the UW-Parkside Library

Mendota Gridiron Club, Inc.

National W Club, Inc.

Friends of the Campus, Inc. (Baraboo)

Friends of WHA-TV, Inc.

Friends of Madison Student Radio, Inc.

Friends of University of Wisconsin Veterinary Medicine Teaching Program, Inc.

Friends of the Golda Meir Library

Foundations

UW-Fond du Lac Foundation, Inc.

UW-Waukesha Foundation, Inc.

Hillel Foundation University of Wisconsin, Inc.

Jennie Bowman FBO UW Memorial Fund

UW-Platteville Foundation, Inc.

Terry Family Foundation, Inc.

UW-La Crosse Foundation, Inc.

UW-Marathon County Foundation, Inc.

UW-Eau Claire Foundation, Inc.

University of Wisconsin Foundation, Inc.

UW-Marinette Foundation, Inc.

UW-Medical Foundation, Inc.

Foundations *(continued)*

UW-Oshkosh Foundation, Inc.
UW-Parkside Foundation, Inc.
UW-River Falls Foundation, Inc.
UW-Stevens Point Foundation, Inc.
UW-Stevens Point Paper Science Foundation
UW-Superior Foundation, Inc.
UW-Whitewater Foundation, Inc.
Wisconsin 4-H Foundation, Inc.
UWM Foundation, Inc.
Stout University Foundation, Inc.
Richland County Campus Foundations, Ltd.
Barron County Campus Foundation, Inc.
UW-Rock County Foundation, Inc.
University Foundation—UW-Marshfield/Wood County
UW-Fox Valley Foundation, Inc.
Washington County Campus Foundation
UW-Sheboygan County Foundation, Inc.
UW-Manitowoc Foundation, Inc.
UW-Green Bay Foundation, Inc.
UW-Platteville Pioneer Education and Development Foundation, Inc. (new)

Real Estate Foundations

UWM Real Estate Foundation, Inc.
UW-Platteville Real Estate Foundation, Inc.
Blugold Real Estate, LLC

Research Organizations

Wisconsin Alumni Research Foundation (WARF)
Center for Advanced Studies in Business, Inc.
Center for Applied Research and Services, Inc.
University Research Park, Inc.
University Research Park Facilities Corp.
WISYS Technology Foundation, Inc.
Morgridge Institute for Research
UWM Research Foundation, Inc.
WiCell Research Institute (new)

Other Organizations

Babcock House

Kelab, Inc.

Madison Family Residency Corp., Inc.

Memorial Union Association, Inc.

University Health Care, Inc.

UW-Madison Supporting Organization, Inc.

William F. Vilas Trust Estate

University Village Housing, Inc. c/o U.W.G.B., Business & Finance

UW-Marathon County Food Service Cooperative

UW-Washington Food Service Cooperative

UW-Marathon County Bookstore Cooperative

Wisconsin Center for Education Products & Services (WCEPS)

¹ As identified by UW System.

² Since FY 2013-14, two organizations—Parkside 200, Ltd., and the Wisconsin Alumni Association, Inc.—are no longer considered affiliated organizations of UW System.

Appendix 2

Apportionment of GPR Offset, by Institution¹

Institution	Based on GPR Reduction ²	Based on Other Factors			Total GPR Offset	
		Pell Enrollment	Institution Enrollment	Faculty Compensation		Presidential Discretion
Milwaukee	\$1,702,500	\$1,652,100	\$ –	\$209,200	\$ 945,000	\$ 4,508,800
Madison	4,748,500	–	–	280,600	(1,029,100)	4,000,000
Parkside	292,500	393,300	347,000	296,600	615,000	1,944,400
Superior	197,500	218,100	490,900	454,200	404,200	1,764,900
Colleges	486,300	1,036,200	–	280,900	(321,600)	1,481,800
River Falls	355,000	368,600	183,300	390,700	93,100	1,390,700
Green Bay	315,000	430,100	228,800	380,100	–	1,354,000
Stevens Point	535,000	609,100	–	477,400	(293,600)	1,327,900
Whitewater	535,000	611,100	–	167,100	(35,900)	1,277,300
Stout	493,800	476,500	–	331,200	(84,700)	1,216,800
Platteville	357,500	454,900	–	476,000	(81,100)	1,207,300
Oshkosh	631,300	–	–	314,400	–	945,700
Eau Claire	652,500	–	–	287,100	–	939,600
Extension	457,500	–	–	414,500	–	872,000
La Crosse	528,800	–	–	240,000	–	768,800
System Administration	53,800	–	–	–	(53,800)	–
Systemwide ³	157,500	–	–	–	(157,500)	–
Total	\$12,500,000	\$6,250,000	\$1,250,000	\$5,000,000	\$ –	\$25,000,000

¹ In each year of the biennium, 2015 Wisconsin Act 55 provided \$25.0 million in GPR to offset a \$150.0 million base budget reduction.

² Based on each institution's proportionate share of UW System's general program operations budget.

³ Accounts maintained by UW System Administration for the benefit of all institutions.

Appendix 3

Level-of-Commitment Categories

“Obligated” balances are held for a purpose as indicated by documentation such as a contract or encumbrance that would make it difficult for the institutions to easily use the balance for other purposes.

“Planned” balances are held for a purpose as indicated by documentation such as a budget document or a memorandum signed by a chancellor. The institutions may use planned balances for other purposes if the use complies with any funding source requirements.

“Designated” balances are held for purposes related to the original funding source, but for which documentation of an obligation or specific plan was not provided. Institutions may use balances for other purposes only if the use complies with funding source requirements.

“Reserves” are balances for which documentation indicates amounts are being held for contingencies, such as an unexpected decline in enrollment.

“Undocumented” balances have no funding source requirements and no documentation of an obligation or plan.

Appendix 4

**Selected Reporting Requirements for
Unrestricted Program Revenue Balances¹**

Program Revenue Source	Calculation	Additional Reporting ²
Tuition (academic student fees and UW-Extension student fees)	Calculate the ratio of the balance to the combined expenditures for GPR (less GPR-funded debt services) and tuition.	When the ratio exceeds 12.0 percent, provide a detailed plan on how funds will be expended. If the balance is negative, provide a savings plan.
Auxiliary Operations	Calculate the ratio of the balance to total auxiliary operations expenditures.	When the ratio exceeds 12.0 percent, provide a detailed plan on how funds will be expended. If the balance is negative, provide a savings plan.
General Operations	Calculate the ratio of the balance to total general operations expenditures.	When the ratio exceeds 12.0 percent, provide a detailed plan on how funds will be expended.
Other Unrestricted Program Revenue	Calculate the ratio of the balance to total other unrestricted program revenue expenditures.	When the ratio exceeds 12.0 percent, provide a detailed plan on how funds will be expended.
Federal Indirect Cost Reimbursement	Calculate the percentage change from the prior year balance.	None.

¹ As approved by the Joint Legislative Audit Committee and Joint Committee on Finance in accordance with provisions in 2013 Wisconsin Act 20.

² When detailed plans are required, the policy specifies the plans should include details on how the funds will be spent, the specific projects for which the funds are held, the amount of funds currently held for each project, and the period in which the funds will be spent.

Appendix 5

Summary of UW System Unrestricted Program Revenue Balances by Level of Commitment

FY 2014-15

Institution	Obligated	Planned	Designated	Reserves	Undocumented	Total
Madison	\$142,582,921	\$164,417,138	\$18,001,401	\$52,249,705	\$ –	\$377,251,165
Milwaukee	16,435,676	29,958,469	18,721,079	–	–	65,115,224
Eau Claire	8,142,060	21,077,210	7,016,279	2,450,865	558,891	39,245,305
Green Bay	2,827,661	10,998,031	2,988,395	3,315,560	467,292	20,596,939
La Crosse	33,398,244	19,535,136	8,892,768	652,533	–	62,478,681
Oshkosh	14,930,328	24,323,938	568,995	3,809,709	15,996	43,648,966
Parkside	1,070,161	7,828,389	1,157,746	349,515	372,164	10,777,975
Platteville	7,136,397	9,876,135	4,921,321	2,114,561	1,589,220	25,637,634
River Falls	6,846,730	13,444,284	636,591	1,267,509	14,126	22,209,240
Stevens Point	11,195,190	13,718,072	1,625,460	5,601,178	1,343,209	33,483,109
Stout	2,970,976	4,881,370	449,270	5,667,479	168,082	14,137,177
Superior	335,989	1,438,389	21,236	(1,376,458)	1,539,379	1,958,535
Whitewater	4,172,746	24,408,336	4,628,830	4,625,000	3,843,470	41,678,382
Colleges	1,163,616	12,381,743	1,472,110	10,705,420	–	25,722,889
Extension	1,010,557	18,012,992	2,423,590	3,725,984	819,942	25,993,065
System Administration	414,871	–	345,246	–	7,915,850	8,675,967
Systemwide	14,605,776	59,146,900	113,413	20,080,528	11,363,244	105,309,861
Total	\$269,239,899	\$435,446,532	\$73,983,730	115,239,088	\$30,010,865	\$923,920,114
	29%	47%	8%	12%	3%	100%

Source: Appendix 3 of UW System's FY 2014-15 Report on Program Revenue Balances by Institution and Level of Commitment.

FY 2013-14

Institution	Obligated	Planned	Designated	Reserves	Undocumented	Total
Madison	\$142,290,995	\$171,996,948	\$17,563,613	\$54,705,680	\$ –	\$386,557,236
Milwaukee	27,500,695	44,404,532	11,229,904	836,000	228,322	84,199,453
Eau Claire	15,663,241	8,722,655	16,954,867	8,262,143	679,689	50,282,595
Green Bay	133,384	6,371,109	8,630,191	6,549,071	516,854	22,200,609
La Crosse	22,091,980	40,004,351	9,359,854	2,408,246	2,341,834	76,206,265
Oshkosh	17,003,847	23,144,512	3,809,867	4,264,543	1,509,113	49,731,882
Parkside	741,664	8,115,977	910,598	(726,546)	55,290	9,096,983
Platteville	7,395,457	11,229,715	2,090,610	256,878	1,732,761	22,705,421
River Falls	5,575,408	10,729,368	1,716,582	1,337,595	303,652	19,662,605
Stevens Point	10,525,311	23,116,723	2,201,808	3,025,957	1,057,895	39,927,694
Stout	5,975,779	5,141,295	448,992	–	356,361	11,922,427
Superior	561,914	1,714,319	547,410	(5,385,787)	621,538	(1,940,606)
Whitewater	5,905,806	26,872,031	6,191,507	3,000,000	3,628,542	45,597,886
Colleges	1,585,146	11,754,873	3,431,711	8,456,296	257,930	25,485,956
Extension	1,786,002	18,712,735	1,867,370	3,720,401	986,591	27,073,099
System Administration	2,455,332	296,206	367,226	–	8,591,977	11,710,741
Systemwide	6,834,088	24,699,990	146,358	20,080,457	41,159,753	92,920,646
Total	\$274,026,049	\$437,027,339	\$87,468,468	\$110,790,934	\$64,028,102	\$973,340,892
	28%	45%	9%	11%	7%	100%

Source: Appendix 2 of UW System's FY 2013-14 Report on Program Revenue Balances by Institution and Level of Commitment.

Appendix 6

Summary of External Investment Managers

As of June 30, 2015

External Manager/Portfolio	Assets under Management ¹	1-Year		3-Year		5-Year		10-Year	
		Performance ²	Benchmark	Performance ²	Benchmark	Performance ²	Benchmark	Performance ²	Benchmark
GMO:									
Real Return Global Balanced	\$113.0 million	(2.0)%	1.3%	8.2%	8.9%	9.3%	8.6%	n.a.	n.a.
Emerging Markets	31.1 million	(9.3)	(5.1)	0.6	3.7	2.3	3.7	6.1%	8.5%
Forestry Fund ³	6.2 million	(7.8)	n.a.	0.9	n.a.	n.a.	n.a.	n.a.	n.a.
UBS:									
Global Asset Management	59.6 million	11.4	7.4	21.8	17.3	18.6	17.3	9.2	7.9
International Asset Management	48.3 million	(5.8)	(3.8)	11.2	12.5	9.1	10.0	4.9	5.6
Adams Street Partners: ⁴									
Private Equity	24.2 million	n.a.	n.a.	11.8	9.7	13.2	11.2	n.a.	n.a.
JP Morgan: ⁴									
Private Equity	25.3 million	n.a.	n.a.	13.0	9.7	12.9	11.2	n.a.	n.a.
Seix:									
High-Yield Debt/Credit	29.7 million	(1.0)	(0.4)	6.7	6.8	8.1	8.6	n.a.	n.a.
Reams:									
High Quality Debt/Credit	46.8 million	2.0	1.9	2.8	1.7	3.7	2.9	5.3	4.2

Total **\$384.2 million**

¹ Based on data from the custodial bank.

² As reported to the Board of Regents in the Quarterly Investment Review as of June 30, 2015. Performance returns that did not meet benchmarks are in **bold**.

³ According to the Office of Trust Funds, it does not establish a yearly benchmark for this fund. The Office of Trust Funds indicates the target rate of return over the life of the investment is from 10.0 to 14.0 percent.

⁴ As of March 31, 2015, due to a lag in reporting related to private equities.

Response ■



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February 12, 2016

Mr. Joe Chrisman
State Auditor
Legislative Audit Bureau
22 E. Mifflin Street, Suite 500
Madison, WI 53703

Dear Mr. Chrisman,

Thank you for the opportunity to respond to the Legislative Audit Bureau's (LAB) audit of the University of Wisconsin System's 2015 Annual Financial Report, which received an unmodified or "clean" audit opinion. We appreciate the time and effort expended in completing the audit of the financial report, as well as the additional areas selected for review and noted within the audit report, including the program revenue balance report, investments, and information technology security.

2015 Audited Financial Statements

As noted within our audited financial report, the UW System's unrestricted net position—those funds without external restrictions as to their use—decreased by \$113.7 million between fiscal year (FY) 2014 and FY 2015. Since 2013, the unrestricted net position decreased approximately \$245.9 million, or 22.8%. Total net position increased due to increases in restricted resources that cannot be used for UW System operations, primarily funds held by the Department of Administration for approved capital projects and a \$330.2 million pension asset that must remain within the state's irrevocable trust fund. A new accounting standard requires a similar asset be reported on the financial statements for all governmental entities within the Wisconsin Retirement System.

Another key financial item highlighted at the February 2016 Board of Regents' meeting was the losses before capital and endowments additions. After considering all operating and non-operating revenues and expenses, the UW System reported a gain of \$202.1 million in FY 2013. With declining enrollments, state appropriations, and federal grants and contracts, the UW System reported losses of \$121.0 million and \$127.8 million in FY 2014 and FY 2015, respectively.

These reductions in unrestricted net position and losses before capital and endowment additions are being reported prior to the more significant \$250 million reduction of state appropriations in the 2015-17 biennium. However, even for FY 2015, it is clear the UW System's financial

condition has deteriorated, and the current path cannot be sustained long-term. All UW institutions are making administrative changes and implementing budget reduction strategies to adjust to their new fiscal realities.

Program Revenue Balance Report

The UW System's program revenue balance report, which is prepared on a budgetary basis, is another management tool that provides valuable financial information. Similar to the accrual-based financial statements, this report reflects reductions in balances. The tuition balances have declined from \$551.5 million in FY 2013 to \$337.4 million in FY 2015, a 38.8% reduction.

We agree with LAB's recommendation related to program revenue reserve policies. UW System Administration will work with the noted institutions to refine their reserves policies and address what the reserves can be used for and who may authorize the usage of those balances.

UW System Investments

The UW System's Office of Trust Funds invests donated funds that total \$523.4 million as of June 30, 2015. Turnover and limited staffing resources during significant portions of the review period contributed to some deficiencies noted in regards to monitoring external investment managers and the completion of various reports, as prescribed in the Investment Policy Statement. As recommended in the report, the Office of Trust Funds will work toward again meeting, and in one case augmenting, the monitoring and reporting standards set forth in the Investment Policy Statement as follows:

- regularly complete, document and report to the Board of Regents regarding annual due diligence meetings with each investment manager;
- for investment vehicles where fees are charged against assets (e.g., mutual funds and other commingled vehicles), annually verify and document that the management fees are consistent with fund terms;
- for the Intermediate Term Fund, report performance against a second benchmark known as the "policy portfolio benchmark"; and
- work with the Board of Regents' Business and Finance Committee members to determine how best to provide detailed investment performance and asset allocation information in the future.

The audit report indicates that investment performance for "four of the nine portfolios [actively] managed by external investment managers lagged benchmark returns for most periods reported." It should be noted that, since inception of our investments, performance for two of these portfolios has met or exceeded their benchmarks. For the other two portfolios, since inception of the investment product or strategy employed, performance has again exceeded benchmarks.

Information Technology Security

Lastly, LAB identified weaknesses related to information technology security policies and procedures. Since the time LAB's audit work was conducted, the UW System is glad to add that the Board of Regents unanimously adopted a new Systemwide policy on Information

Technology Security (Regent Policy Document 25-5,
<https://www.wisconsin.edu/regents/policies/>).

The UW Data Privacy and Security Council has surveyed its members regarding the priority order for the development of new information security policies. The Council will meet in person on February 17th and regularly thereafter to continue this effort.

In response to the LAB findings, the audited UW institutions are ensuring that the fewest possible individuals have access to the internal workings of the systems that store confidential and sensitive information. At the smaller institutions, where small information technology staffs make it difficult to maintain proper separation of duties, mitigating controls are being implemented. The work that is underway at the audited institutions will also inform the policy work of the Data Privacy and Security Council.

While security policies and internal controls need to be strengthened, there is no evidence that the audited systems have been compromised.

Thank you again for the opportunity to comment on this report.

Sincerely,

A handwritten signature in black ink that reads "Ray Cross". The signature is written in a cursive, slightly slanted style.

Ray Cross