The University of Alabama System
The University of Alabama
The University of Alabama at Birmingham
The University of Alabama in Huntsville
The University of Alabama Hospital
The Healthcare Authority for UAB Highlands
Report to Management
September 30, 2009
January 28, 2010

Dr. Malcolm Portera
Chancellor
The University of Alabama System
Tuscaloosa, Alabama 35401-1551

Dear Dr. Portera:

In planning and performing our audits of the financial statements of The University of Alabama System (the “System”) as of and for the year ended September 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing opinions on the effectiveness of internal control over financial reporting. Accordingly, we do not express an opinion on the System's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses as defined in AU 325, Communication of Internal Control Related Matters Noted in an Audit, as amended, of the AICPA Professional Standards as shown below:

- Control deficiency – 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 or detect misstatements on a timely basis.

- Significant deficiency - a control deficiency, or combination of control deficiencies, that adversely affects the System's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

- Material weakness - a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

As we agreed in the audit committee meeting on September 17, 2009, we are providing you with our observations on certain matters involving the internal control structure and its operations, and are submitting for your consideration related recommendations designed to help the System to make improvements and achieve operational efficiencies. **We noted no material weaknesses as a result of our audits.** These comments are not related to significant deficiencies known to us. Our comments herein reflect our desire to be of continuing assistance to the System. Managements' responses to these comments are included as an addendum to our letter. Managements' responses to these comments have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.
Our consideration of internal control does not cover the internal control for Southern Research Institute. This entity was audited by other auditors, whose report thereon has been furnished to us.

Management should also refer to the required communications to the Audit Committee included in the "Report to the Audit Committee" that will be issued on February 4, 2010.

This letter is intended solely for the information and use of the management of the System entities, the Board of Trustees of the University of Alabama, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

If you would like any further information or would like to discuss any of the issues raised, please contact Michael Lammons at (678) 419-1217.

Very truly yours,

PricewaterhouseCoopers LLP
1. Evaluation of Impairment (System Investment Pools)

As a part of our audit procedures to gain comfort over the valuation of the System investment pool portfolios, we evaluated whether any impairment existed related to the investments held at cost within the Endowment and Prime Funds. At September 30, 2009, the Endowment Fund held approximately $80.6 million (or 9.6%) of alternative investments which are reported at cost; the Prime Fund held approximately $11.4 million (or 1.8%) of such investments. In order to evaluate whether any impairment existed, the engagement team first compared the cost basis for each investment to its fair value. For those investments whose fair value had declined significantly from cost basis, the engagement team performed research as well as held a discussion with management of the investment pool in order to gather additional information regarding the current state and future outlook for the investment. As a result of our discussions with management, it was determined that certain investments held at cost within the Endowment and Prime Funds were partially impaired and management did not expect to be able to recover the entire cost basis of the investment. An entry was booked to recognize approximately $4.2 million and $8.9 million of impairment related to the Endowment Fund and Prime Fund, respectively, to adjust the book value of these investments at September 30, 2009.

Management identified an impairment during a due diligence visit in November. We noted that management was knowledgeable about the value of these investments and has procedures in place to identify potential impairments.

We recommend that management continue to review its procedures with respect to evaluating impairment and make changes, when appropriate.

2.  

3. Enterprise Risk Management (System-wide)

Increasing demands for accountability and regulation require higher education leadership to take a comprehensive view of enterprise risks and institute risk mitigation strategies. A methodical approach to balancing the benefits and costs of enterprise risk is increasingly a component of prudent institutional governance and leadership. Enterprise Risk Management (ERM) is a comprehensive, systematic approach for helping all organizations, regardless of size or mission, to identify events and measure, prioritize and respond to the risks challenging its most critical objectives and related projects, initiatives and day-to-day operating practices. ERM is a process effected by an entity’s governing board, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may
affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

Some of the benefits of Enterprise Risk Management can include:

- Fewer operational and financial surprises
- Enhanced planning ability and plan execution effectiveness
- Reduced cost of managing risk
- Lower variability in financial performance
- Reduced cost of capital
- Optimized capital allocation across business units
- Ability to allow management to focus on opportunities to drive value creation rather than responding to crises or other unplanned events

The System should evaluate its current efforts at the individual System entity level and coordinate its approach for the System as a whole to ensure that, at a minimum, all key risks are identified and appropriately addressed.
Management Responses
January 29, 2010

1. Evaluation of Impairment (System Investment Pools)

As a part of our audit procedures to gain comfort over the valuation of the System investment pool portfolios, we evaluated whether any impairment existed related to the investments held at cost within the Endowment and Prime Funds. At September 30, 2009, the Endowment Fund held approximately $80.6 million (or 9.6%) of alternative investments which are reported at cost; the Prime Fund held approximately $11.4 million (or 1.8%) of such investments. In order to evaluate whether any impairment existed, the engagement team first compared the cost basis for each investment to its fair value. For those investments whose fair value had declined significantly from cost basis, the engagement team performed research as well as held a discussion with management of the investment pool in order to gather additional information regarding the current state and future outlook for the investment. As a result of our discussions with management, it was determined that certain investments held at cost within the Endowment and Prime Funds were partially impaired and management did not expect to be able to recover the entire cost basis of the investment. An entry was booked to recognize approximately $4.2 million and $8.9 million of impairment related to the Endowment Fund and Prime Fund, respectively, to adjust the book value of these investments at September 30, 2009. Management identified an impairment during a due diligence visit in November. We noted that management was knowledgeable about the value of these investments and has procedures in place to identify potential impairments.

We recommend that management continue to review its procedures with respect to evaluating impairment and make changes, when appropriate.

Management’s Response

Under GASB rules (as opposed to FASB) alternative investments are valued at cost unless they are deemed to be permanently impaired, in which case they are valued at the lower number. Having gone through the worst financial crisis since the Great Depression, many investments which use leverage have been severely tested, particularly in the real estate area. This lead to our first impairment issue since the System began investing in alternative assets.

These impairment issues revolve around two private REITS (Blackrock Diamond Fund and Clarion Industrial Trust). The managers of these funds operate under FASB and have been accurately reflecting the change in market value by applying FASB 157 (fair value accounting for alternative investments) on a quarterly basis. These accurate market value adjustments have been reported in the monthly statements of the System Office.
Dating back to early 2009, the Chief Investment Officer has been having ongoing discussions with the managers and the Investment Consultant regarding the challenges these funds have had in the current environment and monitoring how they would work through their current funding issues. After a due diligence visit by the CIO in early November 2009, each fund's ongoing plans were presented, analyzed and permanent impairment was confirmed.

Within a week of this confirmation, the external auditors were notified and subsequently worked with the System Office accounting staff to determine the proper accounting treatment of this recognized impairment.

The management letter comment provides us assurance that our procedures do work. The Investment Office staff has a monthly review of alternatives that was put in place several years ago. Management will continue to evaluate our procedures and make changes, if appropriate.

**Corrective Action Plan Contact**

Tom Gale, Chief Investment Officer
3. Enterprise Risk Management (System-wide)

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The System should evaluate its current efforts at the individual System entity level and coordinate its approach for the System as a whole to ensure that, at a minimum, all key risks are identified and appropriately addressed.

Management’s Response

Management concurs and has activities underway to implement a comprehensive Enterprise Risk Management Program. The University of Alabama System has recognized for several years a need for a formal approach to monitoring and evaluating risk. We evaluated best practices and engaged a consultant to work with our system. These efforts culminated in a kick off meeting with the three campuses in September 2009. Since that initial meeting, all three campuses have been engaged in campus specific ERM planning efforts. The Chancellor has planned an ERM update to the Board of Trustees in the summer of 2010.

Corrective Action Plan Contact
C. Ray Hayes, Vice Chancellor for Financial Affairs

#7 Pinehurst · Tuscaloosa, Alabama 35401-1551
Telephone (205) 348-5123 · Facsimile (205) 348-9593 · Electronic Mail crhayes@uasystem.ua.edu