

The Regents of the University of California

COMMITTEE ON AUDIT

November 20, 1997

The Committee on Audit met on the above date at Sunset Commons, Los Angeles campus.

Members present: Regents Clark, Connerly, Davis, Khachigian, Leach, Levin, Nakashima, and Parsky

In attendance: Regents Atkinson, Bagley, Brophy, Gonzales, Johnson, McClymond, Montoya, Preuss, and Soderquist, Regents-designate Miura and Willmon, Faculty Representatives Dorr and Weiss, Secretary Trivette, General Counsel Holst, Assistant Treasurer Stanton, Provost King, Senior Vice President Kennedy, Vice Presidents Darling, Gomes, Gurtner, and Hopper, University Auditor Reed, Chancellors Berdahl, Carnesale, Debas, Dynes, Greenwood, Orbach, Vanderhoef, and Yang, Executive Vice Chancellor Golub representing Chancellor Wilkening, and Recording Secretary Nietfeld

The meeting convened at 11:45 a.m. with Committee Chair Leach presiding.

1. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 1997**

In accordance with the Schedule of Reports, the **Annual Report of External Auditors for the Year Ended June 30, 1997** was submitted for discussion.

Committee Chair Leach invited the representatives of Deloitte & Touche, The Regents' external auditors, to present their annual report. Mr. Rich Fineberg, advisory partner, noted that the objective of the external auditors in performing the basic audit is to render an opinion on the general purpose financial statements of the University of California. In addition, the auditors report their observations and make recommendations with regard to accounting procedures and controls. He recalled that when Deloitte & Touche presented its first annual report to the Committee, the firm raised serious concerns that were described to the Regents in great detail. At that time, President Atkinson and Senior Vice President Kennedy expressed to the external auditors their opinion that change within the University was necessary in its systems and controls. At the November 1996 meeting, Mr. Kennedy outlined management initiatives and financial controls that he intended to implement over the coming year. The auditors note that the chancellors have joined with the Office of the President in implementing these improvements.

Mr. Bob Schapperle, lead client service partner, recalled that a number of adjustments to the financial records were required as a result of the 1996 audit. The auditors discussed with the Committee their recommendations which were designed to improve accountability and controls within the University and to address clinical enterprise issues as well as business

systems challenges and opportunities. Mr. Schapperle reported that during the past year the position of director of financial control and accountability has been established at each campus and within the Office of the President and that most of these positions have been filled. A business process risk assessment pilot program has been initiated at three campuses, and virtually all of the nearly one hundred detailed campus and medical center management letter comments and recommendations that were made in last year's letter to management have been or are in the process of being addressed. During the 1997 audit, management and Deloitte & Touche addressed all areas in which adjustments had been required prior to the end of the year. As a result of this and the attention paid by management to the closing process, there were no significant adjustments resulting from this year's audit. In addition, the audit went more smoothly this year, and the engagement hours were consequently reduced by approximately 20 percent.

Mr. Schapperle noted that the management letter, which was distributed to the Regents with the agenda, contained a number of top-level, systemwide comments, as well as detailed, campus-by-campus comments. No significant issues were identified during the 1997 audit. In spite of the continued progress which is being made, sustained attention is important. The directors of financial control and accountability will need to provide leadership and direction for new efforts which are under way. The support and encouragement of these efforts and individuals by management and the Regents is important. Mr. Schapperle explained that the challenge of the business process risk assessment pilot program will be to obtain the full cooperation and acceptance of the process by the broad constituencies within the University, including academicians, researchers, and others involved in the mission of the University. In addition, the assessment process needs to include corporate culture issues that influence the attitudes and actions of those affected by University policies and controls.

Mr. Jack Krouskup reported that the **Clinical Enterprise Organization Matters** section of the management letter addresses the following five areas: clinical enterprise reporting, control and compliance function within the medical centers, quarterly reviews, physician billing and contractual allowances, and managed care contract accounting. For each area, Deloitte & Touche is aware of significant action by management at the campus level and in the Office of the President, and it expects to have ongoing discussions with management as solutions are developed or implemented which address these matters. The auditors understand that substantive attention is being given to each of these areas. Progress continues in the area of clinical enterprise reporting. During the current year the University formed a task force consisting of representatives from the Office of the President and the various campuses and medical centers to develop a clinical enterprise reporting model. Last year the auditors commented that medical centers operate accounting systems which are separate from those of the campuses, which may not be cost effective. The movement toward an integrated system may eliminate duplication, streamline the control structure, and facilitate the development of a clinical enterprise reporting model. With respect to control and compliance, Mr. Krouskup noted that this area will continue to receive a substantial amount of scrutiny from the federal government. The University has created a Systemwide Compliance

Committee that has developed systemwide compliance guidelines for federal billing which address federal requirements. The campuses subsequently developed a professional fee billing campus compliance plan in accordance with these guidelines. In addition, the University is in the process of developing compliance guidelines which will be applied at each of the medical centers. Management concurs that a comprehensive, well-monitored plan is essential.

Mr. Krouskup recalled that in the prior year letter Deloitte & Touche had recommended that independent quarterly reviews be made of the interim financial statements for the medical centers. During the current year certain procedures were performed at each of the medical centers to review the interim financial information as of December 31, 1996 and March 31, 1997. Reports were issued as a result of these procedures that were presented to the Office of the President and the chancellor at each medical center, resulting in discussions regarding financial results. These reviews will be continued during 1998. The complex issues surrounding physician billing and contractual allowances are receiving significant attention from management. Written policies and procedures have been issued and discussed with the appropriate individuals at each campus.

Mr. Schapperle then turned to the **Business Systems Issues** section of the management letter, which addresses the following areas: Year 2000, Development and Implementation of New Systems, Information Security, and Business Continuity Planning. He reported that at the time of the campus visits the auditors raised high-level inquiries as to the status of assessing and dealing with the impact of the year 2000 on the University's key business operating systems. The auditors found that while some campuses and medical centers had established plans and were dealing with the issues, others had performed minimal preparation for the systems changes which are required for the year 2000. The central information systems group at each campus and medical center is responsible for only a subset of the information processing and control systems of the entity. Responsibility for addressing the year 2000 issue for systems which are not the responsibility of the central information systems group has been left to the departments or system owners. Compliance by these owners is dependent upon the initiatives taken by them to recognize the issues and to take action. Most of the campuses have developed awareness programs and have provided them to the departments, but the auditors did not observe indications of broad-based, campus-wide initiatives undertaken to assess the impact of the year 2000 compliance on non-central systems. In addition, the majority of the medical centers had neither completed inventories of their systems nor finalized their year 2000 planning documents. Some campuses and medical centers are implementing new systems which will eliminate the year 2000 problems. However, in some cases no contingency or fall-back plans have been prepared to address the potentiality that these system implementation projects are not completed on time.

With respect to business continuity planning, Mr. Schapperle reported that, consistent with the approach taken in the year 2000 review, the auditors inquired about the status of the University's readiness for significant business interruptions at each of the campuses and medical centers. Based upon the results of this work, Deloitte & Touch noted that a key

strength of the University is emergency preparedness. In addition, each campus has performed emergency drills to test the plans, and thus the University should be well prepared to deal with the impacts of any emergency or disaster. The auditors' assessment concluded, however, that significant improvement could be achieved in business process recovery, including mission-critical business processes such as admitting patients, paying vendors, and receiving fees from students. Consideration needs to be given to how, where, when, and in what order computing and other systems will be up and operating. Although a few campuses have plans for mainframe recovery, those plans have not been updated recently, and no campus has a comprehensive, well-documented plan for organization-wide, long-term recovery and continuity of operations beyond emergency response activities. The second area with an opportunity for improvement is vital records management in the event of a business disruption that damages and destroys those records. Present records management techniques focus primarily on record maintenance, including retention, storage, and access controls. Deloitte & Touche believes that there are significant benefits to the University in making these improvements but also recognizes that resources are limited. Management has agreed to give priority to the development of a timetable of the steps necessary to improve business continuity planning.

In conclusion, Mr. Schapperle commented on the letter to the Committee on Audit, which discusses recently issued Governmental Accounting Standards Board Statements which have been adopted by the University. The auditors noted that there were no disagreements with management during the course of the audit and that management was fully cooperative.

In response to a question from Regent Clark regarding any examination by the external auditors of the campus internal audit departments, Mr. Schapperle reported that the external auditors had read the principal audit reports that were prepared at each campus in preparation for the audit. Regent Clark asked whether the internal audit structure on each campus was satisfactory. Mr. Schapperle noted that the operations of the external auditors do not address organizational structure but rather quality in terms of the audit reports and the audit personnel. Generally, the quality was found to be high. The primary focus of the external auditors is on the year-end general financial statements of the University. The internal audit departments tend to focus on more detailed activities at the campuses and the medical centers. Regent Clark believed that the Regents should be reassured by the external auditors that no basic weakness exists in any of the internal audit offices.

Regent Leach suggested that if the Regents want a study of the internal audit segment of the University, either Deloitte & Touche or another firm should be engaged to perform such a study because it would not occur during the normal course of the audit. Regent Clark believed that such a review was customary in an external audit and requested that next year's audit include such a report.

Regent Connerly recalled that the practice of overbilling by an outside vendor had recently been detected as the result of complaints from a competitor and asked whether the external

auditors investigate how this type of business practice could be detected. Mr. Schapperle explained that while the annual external audit does not go into this level of detail, he had spoken with management in the Office of the President about a service provided by Deloitte & Touche which investigates issues such as overbilling and double billing. Regent Connerly suggested that there should be a systematic way to determine when these practices occur.

Senior Vice President Kennedy reported that over the past year management had focused its efforts in the financial control area, with favorable results, and on year 2000 compliance. Attention has been given to high-level systems such as the general ledger, and there have been 686 reviews of these systems. The University is confident that the critical mainframe systems are in order, and attention is now turning to other areas. The concerns raised by Deloitte & Touche with respect to issues such as business continuity planning raise the fact that the University will need to make a major investment in new systems. The issue becomes one of priorities.

Regent Davis referred to a recent lawsuit and asked whether the external auditors would have the capacity to investigate the circumstances which led to the judge's decision. Mr. Schapperle responded that Deloitte & Touche has employees who are skilled in forensic accounting. Members of the firm recently worked with a campus in such an investigation. Mr. Schapperle noted that University Auditor Reed is currently recruiting for a fraud auditor who might have these skills. Deloitte & Touche does provide litigation support, although not as a part of the basic audit.

In response to a comment from Regent Parsky, Mr. Schapperle reported that progress had been made by the University in designing a control structure which will address the issues that Deloitte & Touche identified in the prior year's report. Another year will be required, however, to understand how the process actually operates. Regent Parsky suggested that next year's report should concentrate on the progress that has been made once the structure is in place. He observed that there are a number of projects that may need attention and suggested that the external auditors prepare a catalog of these projects in order to ensure that the best expertise is being brought to bear to address them. He asked that there be a presentation to the Committee on what needs to be addressed parallel with the audit.

Regent Leach agreed that problems may exist that the auditors would not be able to uncover. He believed that there should be an identification of such projects as referred to by Regent Parsky and that the University should retain talent either within or outside the University to pursue them.

Regent Leach commended Senior Vice President Kennedy and the vice chancellors for the fact that nearly all of the recommendations which were made in last year's management letter had been implemented. He also recognized the importance of the chancellors' actions in following the recommendation that a director of financial control and accountability position

be established on each campus which will help to maintain better management control in support of the University's educational and research mission.

Mr. Fineberg commented that the support and encouragement of the Regents for management is critical to the endeavor. He suggested that problems such as the one raised by Regent Connerly would continue to arise until the control systems are in place and working. It is the responsibility of the external auditors to report to the Regents as to whether these systems are in fact working.

Regent Leach asked that the Committee be provided with a plan for achieving the goals that have been discussed. Vice President Kennedy explained that it is his intention to present such a report to the Committee in spring 1998. He acknowledged the cooperation of management throughout the University in responding to the recommendations made by the external auditors in 1996.

University Auditor Reed referred to the remarks made by Regent Clark with respect to internal audit. He recalled that during the course of the 1996 audit, Deloitte & Touche had reviewed the charter of the internal audit program and its dual-reporting structure, as well as the internal audit management plan, which divides responsibilities between the campuses and the Office of the President. With respect to the question from Regent Connerly, Mr. Reed believed that an issue such as this would more likely be addressed by the internal auditors.

He noted that in this case the procurement process did not result in contracts that were followed through when the bills were received from the vendors because the campus did not have in place mechanisms to access the bills. The people who were receiving the transcription service were aware of the discrepancy and made verbal amendments to the contracts, which was inappropriate. There was no mechanism in place in the receiving department to assess the accuracy of the bills that were received. Regent Connerly suggested that there should be some way to gauge whether bills are accurate.

Regent Leach pointed out that the University's focus is on research and teaching. The controllers and the vice chancellors need to educate the managers as to the importance of internal controls.

With respect to the issue raised by Regent Davis, Auditor Reed reported that internal audit is available to provide fact-finding services on a wide variety of issues.

[The report was mailed to all Regents in advance of the meeting, and a copy is on file in the Office of the Secretary.]

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 1996-97**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Plans, 1996-97**, was submitted for discussion.

University Auditor Reed observed that the Committee has a paramount interest in how the auditors spend their time. He reported that in 1997, with nearly comparable resources, internal audit devoted almost 12,000 more hours to regular audits than in the prior year, a 16 percent increase. This was accomplished in large measure because of a reduction in hours spent conducting investigations, the first reduction in five years. It was also due to an emphasis on accomplishment of the audit plan as the first priority, with a more disciplined approach to the deployment of resources and a heightened focus on the issues identified as high risk. These efforts fell substantially short of the audit plan for the year, but the plan was intentionally aggressive.

Mr. Reed noted that the annual report contains a number of examples of the accomplishments of the past year resulting from efforts and services that are not traditional full-scope audits. They include consultations, special projects, and advice on systems development and reengineering initiatives. By looking at the internal audit program as an element of the University's internal control structure, one may observe that the range of audit activities represents both preventative and detective controls. The business world in general is increasingly recognizing the value of preventative controls. Regular audits are viewed principally as detective controls. Many activities that are not regular audits are preventative in nature. They serve the same objectives as regular audits but frequently in a more proactive fashion. The objective, however, always remains the same: assuring that the University's business activities are characterized by ethical behavior, accountability, and sound business practices.

Mr. Reed then discussed two services which provide value to the University over and above the regular audit and consultation projects, the first being external audit coordination. Last year internal audit coordinated 157 external reviews by 58 different agencies, mostly federal or private research sponsors. Managers of the programs under review are typically unfamiliar with the audit process. Internal audit's work with the external agencies helps to assure a smooth, timely, and accurate audit process, as well as assuring that issues identified by external agencies receive the appropriate internal attention.

Mr. Reed reported that last year internal audit conducted 130 training sessions to a wide variety of audiences reaching approximately 2,500 university employees. A substantial number of these were done in connection with the new professional fee billing compliance programs in the schools of medicine. Together, these two activities consumed less than four percent of internal audit's time last year, but they gave internal audit the opportunity to have an impact on thousands of University employees beyond those who were subject to regular audit activities.

The annual report describes the distribution of internal audit activities and comparisons to others in the industry. The University's internal auditors are engaged in roughly the same types of activities, and in roughly similar proportions, as others in higher education. This

distribution is managed in three ways. When the plan is initially prepared, guidelines are established by category, with a primary emphasis on concentrating efforts in the regular audits of high-risk areas. During the course of the year there is continuous oversight of the plan execution, and there are quarterly reports to the Committee on Audit about the distribution of audit efforts.

Mr. Reed noted that members of the Committee have been concerned that the auditors' resources were being diverted by management to tasks or projects that do not represent the best use of their time or that may be management's responsibility. He reported that he is now in a position to see every project in progress at every location on a quarterly basis. He also attends nearly every meeting of the campus audit committees where the status of important projects is discussed as well as any revisions to the audit plan. He has found no evidence of undue influence on the auditors' time or evidence of inappropriate uses of their time.

With respect to personnel matters, Auditor Reed reported that a candidate for the director of the fraud audit program had declined the University's offer for personal reasons. He will be interviewing two new candidates, both from the forensic accounting units of Big Six accounting firms.

Second, as chronicled in the annual report, internal audit has experienced increased turnover of approximately 20 percent in the past year. This turnover and subsequent recruitment efforts are cause for some concern about the competitiveness of the University's salaries. Internal audit management will work with Human Resources to assess the marketplace and assure the University's ability to recruit and retain a qualified professional staff.

Mr. Reed concluded by noting that the annual report discusses progress against the strategic plan during the year. This is the plan for strengthening the audit program and is accomplished through the efforts of the audit directors organized into three work groups. One of the more noteworthy accomplishments of the past year was the reestablishment of a peer review program. In the past year, three of the campuses, plus the Office of the President internal audit program were reviewed, and one of the three national laboratories was reviewed by a peer review team from the Department of Energy. Each of these reviews helps assure the quality of the programs and compliance with professional standards, as well as providing opportunities for audit directors to share and exchange ideas for strengthening their programs.

Regent Clark reiterated his belief that the external auditors should perform a review of the internal audit department during the course of their audit. University Auditor Reed stated his intention to work with Deloitte & Touche to ensure that the external auditors are comfortable with the structure of the audit program.

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AUDIT

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November 20, 1997

The meeting adjourned at 12:50 p.m.

Attest:

Secretary