The Regents of the University of California

COMMITTEE ON AUDIT
March 19, 1998

The Committee on Audit met on the above date at UCSF-Laurel Heights, San Francisco.

Members present: Regents Clark, Hotchkis, Khachigian, Leach, Lee, Levin, Nakashima, and Parsky

In attendance: Regents Atkinson, Bagley, Chandler, Davies, Johnson, McClymond, Montoya, Ochoa, Sayles, and Soderquist, Regents-designate Espinoza, Miura, and Willmon, Faculty Representatives Dorr and Weiss, Secretary Trivette, General Counsel Holst, Treasurer Small, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, Gomes, and Hopper, University Auditor Reed, Chancellors Berdahl, Carnesale, Debas, Dynes, Greenwood, Orbach, Vanderhoef, Wilkening, and Yang, and Recording Secretary Nietfeld

The meeting convened at 3:10 p.m. with Committee Chair Leach presiding.

1. **APPOINTMENT OF EXTERNAL AUDITOR FOR THE YEAR ENDING JUNE 30, 1998**

The President recommended that the current external auditor of the University of California, Deloitte & Touche, be reappointed as external auditor for the fiscal year ending June 30, 1998 and that the Secretary be authorized to execute an agreement with Deloitte & Touche covering its services as external auditor of the University of California for that period.

Senior Vice President Kennedy recalled that at the January 1996 meeting of The Regents, after a formal bid and proposal process, Deloitte & Touche was appointed as The Regents' auditor for the period beginning with the 1995-96 fiscal year. The expectation during the bid and proposal process was that the firm selected would be retained for a multi-year period. Based on the January 1996 acceptance of the Deloitte & Touche proposal, the cost of the audit program for the fiscal year ending June 30, 1998 is not to exceed $1,180,000, including estimated out-of-pocket expenses of $92,000. The major difference from last year's audit is that the firm will no longer provide audit coverage to the UCSF medical center as a result of the Stanford merger.

Regent Leach pointed out that these fees are significantly less than those paid to the former external auditor and that the quality of the services provided by Deloitte & Touche is higher.

In response to a question from Regent Lee, Mr. Bob Schapperle, lead client service partner, confirmed that no mergers are currently envisioned for Deloitte & Touche.

Regent Lee commented on the size of the University and the difficulty that size presents to the auditors. Mr. Schapperle agreed that the nature of the University's business presents a challenge, noting that the firm intends to devote 25,000 hours to auditing the University, with a focus primarily on the financial statements.

In response to further comments from Regent Lee regarding the nature of the University's business, Regent Leach noted that each campus and the Office of the President, upon the advice of Deloitte & Touche, had appointed a senior officer to the position of Director of Financial Control and Accountability. This measure was taken in an effort to improve business controls on the campuses.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it the Board.

2. **APPROVAL OF THE EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 1998**

The President recommended that the annual audit plan for the year ending June 30, 1998 be approved.

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

The Committee was informed that the annual external audit plan provides for a financial audit of the University of California and the University of California Retirement System. Additional audit coverage by the external auditor includes the National Collegiate Athletic Association audit, the revenue bond indentures audit, an audit of the four medical centers, and the federal grants and contracts (A-133) audit.

Mr. Schapperle reported that Deloitte & Touche is committed to building upon the experience obtained during its first two years as the University's external auditor. He explained that the audit plan consists of the following guiding principles:

· Continuity of personnel -- Management at all levels of the University has emphasized the importance of continuity in staffing the audit. As a result, 85 percent of the partners and managers who served the University last year will return in 1998.

· Specialized expertise and business-oriented advice -- A key element of the audit is to provide specialized expertise in a broad range of areas, including higher education, health care, information technology and general business systems considerations, tax issues, employee benefit and retirement plans, risk management, and investment operations.

Mr. Schapperle noted that the audit plan identifies the areas on which the auditors' efforts will be focused. The management team consists of more than thirty partners, senior managers, and managers, as well as more than one hundred audit and support personnel. He stated that the goal of the audit would be to meet and exceed the Regents' expectations, noting that the University of California is one of three Office of the Chairman clients out of more than two hundred higher-education institutions.

Turning to the audit plan, Mr. Schapperle noted that it describes in detail a preliminary assessment of financial statement reporting risk. Two new elements are the accounting for the transfer of the San Francisco campus' medical center assets and an increased focus on private research funding compliance requirements. The University's role as a leader in the development of cooperative relationships with private industry elevates the level of accountability that the University has with these partners, as well as with the general public.

Mr. Jack Krouskup, lead service partner for the medical center engagements, explained that the audit will focus heavily on the control environment, with a significant concentration on higher-risk areas. Consistent with previous discussions with the Regents, those areas will include managed care contract accounting, physician billing, and contractual and third-party settlements allowances. The University has established more comprehensive accounting policies related to managed care contracting, and the auditors will assess compliance with these new practices during the audit. Mr. Krouskup recalled that at the November meeting he had outlined five areas that were included in the management letter pertaining to the 1997 audit. These matters included clinical enterprise reporting, control and compliance, quarterly reviews, physician billing, and managed care contracting. Deloitte & Touche continues to perform limited quarter-end procedures at each of the medical centers, which include discussions with management regarding progress that has been made in responding to the management letter observations. Based on these discussions, the auditors believe that attention is being given to these matters. During the course of the 1998 audit, the auditors will develop a more substantive understanding of this process and will report to the Committee in the fall.

Mr. Schapperle observed that, given the size of and level of decentralization that exists at the University, the Internal Audit department becomes an important component as the auditors consider how the University's size and decentralized controls could lead to a material misstatement within the financial statements. The auditors will consider the following aspects of the internal audit function: the mission statement, the management charter and management plan, and the administrative guidelines for internal audit dual reporting relationship. Based in part on their understanding of the Internal Audit department, the auditors plan to rely on certain aspects of the work of the Internal Audit department during the course of the year, especially with regard to the testing of information technology controls at a number of the campuses. The auditors plan to identify and discuss issues with management early and in a manner that will result in their efficient resolution prior to year end.

In response to questions from Regent Leach regarding the prior year's audit, Mr. Schapperle reported that the auditors had had no disagreement with management and that there was nothing which came to the auditors' attention which was not disclosed in either the audit or the management letter which should be brought to the attention of the Committee.

Regent Nakashima referred to the section of the audit plan which discusses physician billing and asked whether the auditors were recommending any changes to these procedures. Mr. Krouskup recalled that extensive process reviews were performed during the first audit at each of the medical centers. No material weaknesses or reportable conditions were uncovered. Mr. Shapperle stated the intention to focus on two new systems during this year's audit. He confirmed for Regent Nakashima that some phyicians do receive money directly from patients at one of the medical centers. Deloitte & Touche has been engaged to perform a detailed audit of the physicians' billing practices at that medical center. The key to the situation is either a systemwide or University-controlled billing system.

In response to a question from Regent Nakashima regarding the Office of Risk Management, Mr. Schapperle recalled that two years ago Deloitte & Touche was engaged to review the risk management process within the Office of the President and on the campuses. In the course of the regular audit, the auditors perform detailed tests of amounts that are paid out as a part of the risk management process. Because of a prior defalcation, the Office of Risk Management is an ongoing area of risk, and detailed procedures are performed there.

Regent Lee asked for an explanation of how the auditors determine the level of risk. Mr. Schapperle explained that the auditors consider either the percentage of total assets or revenues of the organization. In some cases the amount is lowered in consideration of certain risks. In the case of the financial statement adjustments in 1996, a cut-off point of $5 million was established.

In response to a question from Regent Lee, Mr. Schapperle reported that to date the auditors have had no disagreements with management. If such a disagreement arose, Deloitte & Touche would work with the audit manager and, failing that, would discuss the problem with management at the Office of the President. The auditors would contact the Chair of the Committee if proposed adjustments were not made by the University.

President Atkinson pointed out that if there were any disagreements between the University and the auditors, regardless of the amount of money involved, the matter would be brought to him for discussion. If he continued to have concerns, he would share them with the Chair of the Committee. Regent Leach reported that he meets twice a year with Mr. Shapperle and Mr. Fineberg; they clearly understand that they are working directly for the Board of Regents.

Regent Clark referred to Building 100 at the medical center, Los Angeles campus. He suggested that the auditors should look at the arrangement for the construction and management of this building to ensure that the University is receiving money to which it is entitled. In addition, there is a trigger factor which gives the University the right to buy the building; it would be important to know whether that trigger point has been reached. Mr. Krouskup assured Regent Clark that Deloitte & Touche's Los Angeles office would look into the matter. President Atkinson stated that he would ask Senior Vice President Kennedy to work with the auditors to ensure that the administration understands the issue and then report back to the Regents. Regent Leach stated that while he agreed that the auditors should look into the matter, primary responsibility for the agreement lies with the Los Angeles campus, and thus he asked that the Chancellor provide the information to the auditors. Following consultation, the auditors and the Chancellor should respond by letter to the Committee in order to answer the questions raised by Regent Clark.

Upon motion duly made and seconded, the Committee approved the President's recommendation and vote to present it to the Board.

The meeting adjourned at 3:35 p.m.

Attest:

Secretary