The Regents of the University of California

COMMITTEE ON AUDIT
November 18, 1999

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

Members present: Regents Bagley, Davies, Moores, Sayles, Taylor, and Vining

In attendance: Regents Atkinson, Hopkinson, O. Johnson, S. Johnson, Khachigian, Kozberg, Lansing, Leach, Lee, Montoya, and Preuss; Regent-designate Kohn, Faculty Representatives Coleman and Cowan, Secretary Trivette, General Counsel Holst, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, Gomes, and Gurtner, Senior Associate to the President Pister, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Dynes, Tomlinson-Keasey, Vanderhoef, and Yang, Vice Chancellor Suduiko representing Chancellor Greenwood, University Auditor Reed, and Recording Secretary Bryan

The meeting convened at 2:55 p.m. with Committee Chair Vining presiding.

1. APPOINTMENT OF EXTERNAL AUDITOR FOR FISCAL YEARS 2000-2002

The President recommended that The Regents select the University's External Auditor for the three-year period beginning with the 1999-2000 fiscal year, following a presentation by the External Audit Evaluation Committee.

It was recalled that at the September 1999 meeting the President was authorized to seek proposals from national independent accounting firms for conducting the annual examination of UC's financial statements beginning with the 1999-2000 fiscal year. An External Audit Evaluation Committee was established by the President and chaired by Vice President Broome to conduct the proposal process. The Committee included representation from the campuses, medical centers, Treasurer's Office, and Office of the President. The Chairman of the Audit Committee also participated in the proposal process. The Request for Proposals resulted in responses from three firms.

Vice President Broome described the evaluation process and its results. The mission of the evaluation committee was to develop the Request for Proposals, the bid process, the evaluation criteria, evaluate firms against the established criteria, and make a recommendation to the Committee on Audit. The three firms that submitted proposals were PricewaterhouseCoopers, Deloitte & Touche, and KPMG. The accounting firms as a group visited each campus and medical center, and the Office of the President. It was important to the evaluation committee that the firms were on equal footing throughout the process. Based on their written proposals, the evaluation committee determined an initial ranking of the firms and received oral presentations. Each firm was measured against the following criteria: firm and team qualifications; staffing commitment; audit approach; written proposal; oral presentation; and fees and services. The evaluation criteria were assessed point values reflecting the committee's weighting of the relative importance of the factors. Members of the committee consulted with their constituents regarding the respective audit area. The members' individual evaluations and rankings were consolidated, and a composite rating was derived for each firm. A single overall quality rating was developed, not taking fees into account. PricewaterhouseCoopers (PWC) received the highest rating, followed by KPMG and Deloitte & Touche. PWC had committed their leading industry resources to the University. Their national higher education specialist will relocate to northern California, and his primary engagement will be UC, where he will spend 1,500 hours. Their key industry healthcare specialist will also be involved in the engagement and will work with their California healthcare specialist. PWC's proportion of partner time devoted to the examination will be 14 percent.

The committee then evaluated the proposals in terms of fees for the three-year period. A comparative analysis showed that KPMG and PWC would charge about $1.4 million for the first year audit. Both firms indexed their fees for the following two years, PWC at about 6 percent and KPMG at about 3.5 percent. Deloitte and Touche proposed an initial fee of $2.3 million which would increase by 13 percent and 11 percent for the following two years. In looking at the annual examination fees for the first year, the difference between the highest bidder and the lowest was $949,000 a year. The difference was $905,000 for the next-to-lowest bidder. Over the three-year contract period, the difference would be $3.6 million and $3.4 million respectively. A final overall rating was determined in which PWC received 282 points out of a maximum of 325; KPMG was 273; Deloitte & Touche was 225. Based on this outcome, the committee recommended PWC as auditor.

A presentation was then made by PricewaterhouseCoopers LLP in which the presenters discussed the general approach they intended to use if they were selected as the University's auditors. The presenters included Mr. Carmine Guerro, managing partner; Mr. Bob Forrester, engagement partner; Mr. Bill Stulginski, healthcare advisory partner; Mr. Gary Garbrecht, medical center team leader; Ms. Joan Murphy, administrative audit partner, and Mr. Mike Schini, laboratories service partner.

Regent Bagley noted that PWC listed as clients the UCSF Foundation and the UCLA Foundation. Mr. Forrester responded that PWC serves universities and their foundations in other areas and is attentive to preventing any conflict of interest from arising.

Regent Leach asked about the number of hours, noting that in the last few years UC audits have been in the range of 23,000-33,000 hours. PWC proposes only 19,900 hours. Mr. Forrester noted that PWC has added 1,200 more hours to consider work in the laboratories and additional support for the medical centers, for a total of about 21,000 hours the first year. Experience has suggested that will be sufficient, but he emphasized that PWC is committed to use all the hours necessary under a not-to-exceed fee arrangement.

Regent Leach believed it was important to emphasize that the external auditors are selected by and work for The Regents. Mr. Forrester acknowledged that PWC will be The Regents' auditors.

Regent Lee asked how the external auditors will work with the University's internal auditors. Mr. Forrester responded that he intends to have a program that is coordinated fully with University Auditor Reed's program.

Committee Chair Vining asked for the names of selection committee members. Vice President Broome reported that the committee included herself and the following people: University Auditor Reed; John Plotts, Director of Financial Management; Bob Yastishak, Director of Treasury Operations; Steve Relyea, Vice Chancellor, UCSD; Sergio Melgar, Chief Financial Officer, UCLA; Sue Ables, Controller, UCLA; Tom Vaney, Vice Chancellor–Business and Administration Services, UCSC; Donna Carpenter, Controller, UCSB; Jim Dolgonas, Assistant Vice President–Information Resources and Computing; Jorge Ohy, Manager for Federal Reports Costing Policy and Analysis; and Wendell Brase, Vice Chancellor–Business Services Administration, UCR. Committee Chair Vining attested to the quality of the selection team.

Regent Leach commented that the process requires those being audited to select the auditor for The Regents. In the past, presentations by those competing were made to the management group, followed by presentations to the Committee on Audit, with all Regents present. The last time an auditor was chosen, the management group did not put a recommendation forward. He was concerned also about the possibility of establishing a reputation for firing auditors who did a good job. Although he accepted the commitment of PWC to do whatever was necessary to handle the job, he emphasized that KPMG's previous University audits were about 23,000 hours and Deloitte & Touche's were between 24,000 and 33,000 hours. The per-hour rate of PWC was $7.50 per hour higher than the rate proposed by Deloitte & Touche, totaling a difference of $180,000 for the audit. Committee Chair Vining responded that this fact was a concern of the evaluation committee and was discussed with each auditor. The bids were not-to-exceed numbers, so the actual number of hours worked will not be billed. He believed that the percentage realization of hours in each bid versus actual hours was the true consideration. Regent Leach emphasized that the auditors must be willing to put in the hours necessary to do the job. Committee Chair Vining was confident that the necessary hours will be put in.

Upon motion duly made and seconded, the Committee approved the President's recommendation of PricewaterhouseCoopers LLP as the University's External Auditor and voted to present it to the Board.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 1998-99**

In accordance with the Schedule of Reports, the Annual Report on Internal Audit Activities, 1998-99 was submitted for discussion by the Committee on Audit.

University Auditor Reed commented that the internal audit program encompasses three major activities—audits, investigations, and advisory services—plus activities directly supporting the internal audit program. In total, the hours spent in these activities, although about 10,000 more than the previous year, were about 2 percent below the plan, which is positive in view of the higher-than-expected turnover of personnel during the year. All of the incremental hours plus the hours saved in investigations were devoted to increased audit work, which grew by over 13,000 hours. In general, the University's audit time is deployed in proportions similar to industry averages. The program strives for balanced and broad coverage across the spectrum of University activities. The auditors spent more than 25 percent of their time in financial management areas, which are the fundamental accounting operations of the University. The next three elements—campus, health sciences, and laboratory activities—accounted for 21 percent of their time. Slightly more than 14 percent of their time was spent in support services such as book stores, parking, and housing, many of which are stand-alone business units with major cash operations. Nearly 11 percent of their time was spent in information technology areas, due mainly to an ongoing effort to review the University's Y2K preparedness. Construction received increased attention because of the growth of the capital program. Combined, the areas mentioned accounted for more than 75 percent of the auditors' time.

University Auditor Reed noted that a process of risk assessment is used to determine where the auditors should spend their time. Risk assessment relies on knowing what is going on in the organization and whether the controls are operating as intended and as represented. He noted that only 5 percent of investigations were launched as a result of internal or external audit findings. Fifty percent of fraud was identified by management. The other major sources of information leading to investigation are whistle blowers and UC police. Auditors then determine the root causes of the fraud. Preventive audit activities, collectively referred to as advisory services, encompass consultations on how to interpret and apply University policy, training in control aspects of new business systems, assistance to management in the design and implementation of controls, and special projects to address known business risks or changes in circumstances. The auditors are accessible to any business manager in need of advice. A revised strategic plan for improvement of the audit program has goals supported by a work plan for teams to which specific goals are assigned.

Mr. Reed commented on the personnel of the internal audit program. Through recruitment and training, the skills of the professionals continue to be enhanced. All open audit director's positions were filled during the year through a combination of internal promotion, movement among locations, and recruitment of outside professionals.

Regent Hopkinson asked about the structure reflected on the organization chart. Mr. Reed explained that the chart shows his dual reporting responsibility to the Committee on Audit and to Senior Vice President Kennedy. The campus audit directors also have dual reporting relationships, to a vice chancellor or deputy director and to Auditor Reed. Regent Hopkinson asked whether the University Auditor audits the activities of the Office of the President. Mr. Reed explained that the Office of the President has a staff of ten professionals. Regent Hopkinson asked why no controls assessment function was listed under the new strategic plan. Mr. Reed noted that the controls assessment initiative comes under the purview of Vice President Broome.

Committee Chair Vining praised Mr. Reed for his accomplishments during the year.

3. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 1999**

In accordance with the Schedule of Reports, the Annual Report of External Auditors for the Year Ended June 30, 1999 was submitted for discussion.

It was recalled that the object of The Regents' external auditors in performing the basic University 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.

Mr. Bob Schapperle, lead client service partner for Deloitte & Touche, introduced Mr. Steve Burrill, the partner who leads the medical center teams, and presented the results of the 1999 audit of the financial statements. He believed that Deloitte & Touche had met and exceeded the Regents' expectations during the past four years. He noted that, during this period, the management letter comment process included over 200 comments on a wide range of subjects that provided a stimulus for change and improvement. A controls initiative has been put in place that includes controllers at each campus and a systemwide control assessment process using an approach pioneered by Deloitte & Touche. There is also a better understanding of the clinical enterprise system and its new reporting model. Significant attention was focused on information Y2K compliance, security, and disaster recovery planning. The accuracy of interim financial reporting at the medical centers has been improved. He believed that, although change takes place slowly, the improvements initiated by Deloitte & Touche would become evident over time.

Mr. Schapperle noted that, with respect to the management letters, the approach of Deloitte & Touche to the process was new this year. The current year's letter points out only matters that require direct Regental attention. Other matters have been communicated directly to the campuses and laboratories, with copies of those letters provided to the Office of the President. The summary management letter contains three comments. The first comment concerns the controls initiative currently under way. Progress has been made, but there is a need to increase the pace. The controls initiative is taking place at both the strategic and the process levels. He believed that more needs to take place at the financial process level, where the controllers can provide the most value. The review of the cashiering process across the system used a consistent approach and is an excellent model that could be adapted to other financial processes. He believed that these other financial processes need to be identified and prioritized quickly and resources allocated to implement the reviews.

The second comment concerns the clinical enterprise. Mr. Burrill noted that the University's five medical centers historically have generated profits that have helped subsidize the research and academic missions of the schools of medicine. In October 1998, the Balanced Budget Act substantially reduced reimbursement from Medicare for serving patients. In January 1999, there were reductions in contract rates from other payors. At the same time, there were significant increases in pharmacy and labor costs. Those factors reduced the cash flows and operating profits for the University's medical centers during the past year. He believed that management attention to these issues will be critical in maintaining the superior nature of the University's medical programs. Also, financial reporting of the medical centers that includes the schools of medicine and the clinical activities of the physicians within those schools gives a full picture of the medical enterprise and is advisable.

Mr. Schapperle's last comment concerned information systems. He noted that last year, as a result of comments made in prior years, the Office of the President issued updated security guidelines which included requirements for disaster recovery plans. During the past year, the auditors found varying degrees of implementation of these requirements. This year it is recommended that each campus and medical center develop time lines for early implementation of these guidelines.

Committee Chair Vining requested that the Regents receive a detailed response before the January meeting from University management regarding the topics brought up in the auditors' management letter.

Regent S. Johnson asked for more detail about the clinical enterprise reporting program. Mr. Burrill explained that the clinical enterprise has two components—the hospitals and the clinical activities of the physicians. Currently, audit reports do not include the physician activities. They are imbedded within the different departments in the schools of medicine. The challenge is to segregate them from the academic and research components of the individual departments and have them reflect accurately the clinical physician activities so that the system may be understood as a whole.

Regent-designate Kohn noted that at some academic medical centers the physicians' side of the income revenues is allocated to separate entities such as foundations, in which the physician billing is done through a separate organization to which the dollars accrue. Only portions come back to the university. He asked if that were the case with UC. Senior Vice President Kennedy explained that all of the income generated through the practice plans accrues to The Regents. Those dollars are used to pay salaries and improve academic programs in the medical centers. The enterprise reporting under discussion takes a step that would correct a historical quirk in which the practice plans have been lodged in the medical schools and those incomes have been booked on the medical school side, whereas the hospitals have been a separate entity from an accounting point of view. The attempt is to cross-allocate those incomes and those costs and put them either on the medical school or medical center side as appropriate, in order to provide a fuller picture of medical center and medical enterprise activities. The overall University financial statements include those activities. They are audited and separately accounted for within the medical school, not the medical center, for which separate reports are issued.

Regent Sayles commented that Mr. Schapperle and his team had done an extraordinary job and were always very responsive to the Regents. Committee Chair Vining concurred in his opinion.

The meeting adjourned at 4:10 p.m.

Attest:

Secretary