The Regents of the University of California

COMMITTEE ON AUDIT
November 16, 2000

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

Members present: Regents Connerly, Davies, S. Johnson, Kohn, Lee, and Parsky

In attendance: Regents Atkinson, Bustamante, Fong, Hertzberg, Hopkinson, O. Johnson, Lansing, Miura, Montoya, and Preuss, Regents-designate T. Davis, Morrison, and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Interim Treasurer Bowman, Senior Vice President Mullinix, Vice Presidents Broome, Drake, and Saragoza, University Auditor Reed, Chancellors Berdahl, Carnesale, Cicerone, and Greenwood, Executive Vice Chancellor Grey representing Chancellor Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 2:10 p.m. with Committee Chair Connerly presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of May 17, 2000 were approved.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 1999-2000**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Activities, 1999-2000**, was submitted for discussion.

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

University Auditor Reed presented the annual report. He reported that the internal audit departments averaged six more auditors on staff than in the prior year, producing a record number of hours for audit activities. Turnover continues to be high, and recruiting is difficult due to the economy and the high cost of living near many UC campuses. These factors, however, mainly affect the ability to recruit more senior managers and those with highly specialized skills. The number of audit staff is still below the planned level, and resources continue to be augmented with contract auditors and hired specialists in areas requiring greater expertise. The greatest challenge is to assure that the University has an adequate number of auditors with the specialized skills needed to audit its vast range of activities. Management must be willing to make investments where the risks warrant securing additional technical resources. The turnover in audit staff is exemplified by the fact that 40 of the 110 registrants at the biennial All Auditors Conference were attending their first conference. Mr. Reed noted, however, that the current group of auditors is characterized not only by their freshness but also by seasoned auditors who represent the most skilled and diverse group that the University has ever had.

University Auditor Reed reported that this week marks the conclusion of a mandatory training program for all University auditors in basic information technology controls. On average, auditors received 81 hours of continuing professional education during the year.

Mr. Reed described some of the year's accomplishments, recalling concern for cashiering and banking controls in the wake of the $4.5 million defalcation at the San Francisco campus. In partnership with the campus controllers, internal audit conducted a comprehensive systemwide review of controls and validated their existence and effectiveness. While the controls were found to be good, a number of improvements were made as a result of that effort.

Internal audit spent 3,600 hours assessing the University's preparedness for Y2K. These studies resulted in a thorough understanding of the University's systems and disaster recovery capabilities.

In terms of other major risk areas, construction received heightened attention, with some degree of construction auditing at every location except for one Department of Energy laboratory.

At the health sciences campuses, internal audit was involved in the development of the corporate compliance programs and the preparations for compliance auditing as those programs become fully implemented and as the PATH audit process concludes. Mr. Reed reported that he has convened the five health sciences campus audit directors, who have created a compliance audit program that will be carried out at each location to assure consistency and to leverage the specialized skills that have been acquired.

University Auditor Reed presented some key statistics from the annual report. Internal audit produced 361 audit reports during the year, and 92 audits were in process at year-end. This represents a completion of 65 percent of the projects in the plan as approved by The Regents. Twenty percent were in progress at year-end, while 15 percent were either deferred to the current year or dropped because of changing priorities. The auditors experienced no serious challenges to their authority to audit anything and to gain access to all University books, records, property, and personnel.

Internal audit performed 159 investigations during the year which consumed nearly 27,000 audit hours. While this is an increase of over 5,000 hours, the UCSF cashiering review consumed 6,000 hours and accounted for all of the increase. That investigation was complex in terms of the effort to prove transaction by transaction how the defalcation was carried out. The University has only recently been able to file the bonding company claim. The dollar amount of loss has not changed from the amount reported in July 1999.

Internal audit devoted 22,000 hours to advisory services, including internal control and fraud awareness training, advice on control aspects of new systems development, and many special projects and consultations designed to avoid future problems.

Mr. Reed reported that, over the last year and a half, he had been working with a group of people to develop a new policy for reporting and investigating allegations of impropriety. This year, changes went into effect in the California Whistleblower Protection Act which make it necessary to comport University policies with the new law. The changes in the whistleblower protection law make it easier for parties to become whistleblowers, and it expands whistleblower protection in the health care setting to include patients. The biggest single change in the law is in the definition of what is called a "protected disclosure," defined as "any good faith communication that discloses or attempts to disclose information that may evidence an improper governmental activity or any condition that may significantly threaten the health or safety of employees or the public if the disclosure was made for the purpose of remedying that condition."

The challenge for the University under the new law is operational. Under current University policy, persons seeking whistleblower status are directed to a central point designated at each location to fill out and sign an official whistleblower form asserting their allegations. Under the new law, the phrase "any good faith communication" precludes designating a central reporting process. In addition, under the existing University policy, whistleblower reports are required to be in writing. Under the new law, they may be made orally. Internal audit has interpreted the law to imply that any University employee with supervisory responsibility, and others with the implied authority to act on the disclosure – such as auditors, compliance officers, and senior officials – must be prepared to recognize a potential protected disclosure when it is made and must know what course of action to take.

The policy under development provides guidance to employees at all levels in identifying protected disclosures, reporting alleged improper activities up through their chain of command or to an appropriate official, assuring that all reported matters are acted on appropriately, and assuring that the rights and confidentiality of both accused and accusers are protected and that acts of retaliation are avoided. The policy will require each location to establish local procedures for elevating every allegation to an appropriate point where it can be reviewed by those with the authority to investigate or cause others to investigate. There will be a more centralized focal point for all allegations to flow to and be reviewed for assignment of investigative responsibility. In that way, there should be improved accountability, improved assignment of the most appropriate resources to investigate the matter, and improved communications with senior management, the Office of the President, the Regents, and the original whistleblower in most cases. In addition to policy development, employees will need to be educated about their rights and obligations.

In concluding his remarks, Mr. Reed commented on the ways in which internal audit continued to strengthen its program. Completing a long development effort, internal audit has put into effect a systemwide audit manual that provides professional and operational guidance to assure consistent performance. In addition, the quality assurance program has been revamped, and another round of internal peer reviews will commence next quarter. At the same time, internal audit has remained committed to pursuing the recommendations from the external review of the program conducted two years ago. The members of the review team have assessed progress against their recommendations and will issue a report, which will be forwarded to the Committee.

In response to a question from Regent Lee, University Auditor Reed believed that the University's experience with respect to risks, exposures, and the amount of time devoted to investigation is fairly comparable to that of other major institutions. In response to a further comment by Regent Lee, Mr. Reed noted that the annual report contains a complete listing of the 361 audit reports issued during the year by campus or laboratory and by audit area. The report provides a chart on the distribution of audits in terms of hours and percentages, which is intended to give the Regents an assurance that there is balance in the internal audit program.

Regent Connerly referred to the relatively high turnover among audit staff, which suggests that the University is not providing career-path opportunities. Mr. Reed recalled that internal audit had lost approximately twenty staff members per year systemwide over the past four years. In 1999, of the twenty who left, eight took another position within the University. In 2000, the number had fallen to three. During the past year there was complete stability at the audit director level.

Regent Connerly asked whether there was a specific plan in place to address the ongoing problem of having to compete with the private sector. Mr. Reed explained that the program is able to manage with the present level of turnover as long as there is stability at the top. However, all Bay Area locations have found it necessary to reclassify auditor positions to make them more competitive with private industry. Historically, an internal audit program has been intended as a training ground for other opportunities within the organization or outside.

Regent S. Johnson referred to the new whistleblower policy and asked about the definition of a "good-faith communication." Auditor Reed acknowledged the risk of spurious allegations from disgruntled employees. Experience to date, however, has shown such communications to be almost nonexistent. The University will need to educate all of its employees who serve in supervisory positions and may become recipients of a protected disclosure.

3. **ANNUAL REPORT OF THE EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2000**

In accordance with the Schedule of Reports, the **Annual Report of External Auditors for the Year Ended June 30, 2000** was submitted for information.

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

It was recalled that the objective 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. The report on the audit for the year ended June 30, 2000 was prepared by PricewaterhouseCoopers LLP, external auditors of The Regents.

Senior Vice President Mullinix introduced the following members of the PricewaterhouseCoopers management group:

Mr. Robert Forrester, Engagement Partner
Mr. Carmine Guerro, Senior Service Partner
Mr. Gary Garbrecht, Medical Center Partner

Mr. Forrester recalled that PricewaterhouseCoopers (PWC) was first appointed as The Regents' external auditor in November 1999; the external audit plan was presented to the Committee in March. The report consists of two parts: the communication of financial-statement matters that merit the attention of the Regents under professional standards and a summary of comments provided to management at the Office of the President, the campuses, the medical centers, and the Department of Energy laboratories. PWC has completed its audit of the June 30, 2000 financial statements of the University of California and reported on them. However, the financial report for the UC San Francisco Medical Center has been delayed pending the completion of the audit of UCSF Stanford Health Care upon its date of dissolution. UCSF was included in the University's financial statements based upon preliminary balances as of September 26, 2000. Any differences between the preliminary and the final balances will be addressed in fiscal year 2001 as current-year adjustments.

Mr. Forrester gave an overview of the financial reporting matters discussed in the report. Under professional auditing standards, PWC is required to communicate to the Committee on Audit all significant adjustments that arose from the audit. He reported that all of the opinions are unqualified. He drew attention to the fact that, effective for fiscal year 2000, the University changed its accounting policy to include in the financial statements employee and other participants' interest in external mutual funds in the Defined Contribution Plan and the Retirement Savings Plan. Such interests amounted to approximately $1.7 billion at June 30, 2000. The University believes, and PWC concurs, that the new treatment is a preferable one because it recognizes the University's fiduciary responsibility for participants' interest in these mutual fund options.

Under professional standards that first apply to the University in fiscal year 2000, PWC is obliged to provide The Regents with a summary of audit adjustments that have not been recorded in the financial statements due to their immateriality. The net total of these adjustments is approximately $1 million. It is important to note that the cumulative effect of the proposed adjustments is less than one percent of the fund balances of the University. These adjustments are typical of large organizations and most result from timing differences. The University has concluded, and PWC concurs, that these adjustments are not material to the financial statements taken as a whole and will instead record them in the next fiscal year. The respective sites have been advised to modify their procedures where appropriate to reduce the frequency of such entries in the future.

Turning to the accounting estimates section of the report, Mr. Forrester noted that the University's financial statements contain adjustments and estimates which have been recorded in the normal course of reflecting the University's operating activity each year. PWC is required under professional auditing standards to determine that the Committee on Audit has been informed about the process used by management in formulating accounting estimates. The most significant accounting estimates include the following:

- Self-insurance reserves are established by an independent actuary for categories such as workers' compensation, professional liability, and health and welfare plans.

- Reserves for bad debts, contractual allowances, and third-party receivables in the clinical enterprise are to be established in compliance with generally accepted accounting principles and specific University policies. PWC has reviewed the third-party and bad debt reserves in the course of the audit and believe that they are neither inadequate nor excessive at any of the medical centers.

- Pension reserves are established on the basis of calculations by the University's independent actuary.

- The carrying value of private investments is based on estimates reported by the partnership as of March 31, 2000, the latest date available before year-end, adjusted for cash transaction between then and June 30.

PWC believes that the estimating practices for each category are appropriate. Recommendations pertaining to improvements will be contained in the management letter.

Turning to the audit of the medical centers, Mr. Garbrecht reported that all of the opinions are unqualified, with the exception of UCSF. There has been a change in the allocation of costs between "costs" and "health system support." The University has, with the concurrence of PWC, adopted for fiscal year 2000 more explicit guidelines for allocating costs on the separately issued operating statements of its medical centers. The Office of the President made the change in order to distinguish the costs that provide an economic benefit to the medical center ("expenses") from other amounts (transfers or "health system support") that do not. This new policy will bring the medical centers more into conformity with generally accepted accounting standards (GAAS) as reflected in general industry practice. Had this change been in effect in 1999, it would have increased operating income for the medical centers by approximately $30 million and decreased the amounts reported as transfers by the same amount. There would have been no effect on the overall change in net assets.

Mr. Forrester reported that PricewaterhouseCoopers had been working closely with the University on the implementation of new accounting and reporting principles and standards. In its next two fiscal years, the University will be required to adopt new accounting standards issued by the Governmental Accounting Standards Board (GASB). In addition, the Securities and Exchange Commission (SEC) has begun to pay attention to hospital debt issues as a result of recent failures in the healthcare market. The SEC lacks the authority to impose specific requirements on bond issuers, but its rules do apply to the timing and accuracy that is submitted by the University's continuing disclosure requirements to the trustee and to nationally recognized municipal securities information repositories. Recent SEC enforcement cases have suggested that there may be risk to an issuer who either discloses information to the market that no longer reflects the issuer's financial condition or discusses financial results with a limited number of current or potential investors. PWC has recommended that the Office of the President discuss with the University's bond counsel a response to certain proposed voluntary "best practices" drafted by organizations in the securities industry and supported by the SEC that are related to the disclosure of information related to the University's revenue bonds.

Mr. Forrester noted that the University's external auditors are required to communicate to the Committee on Audit all significant deficiencies in the design or operation of the University's internal control structure. GAAS set forth two levels of weakness. The first is material weakness, in which a material error in the financial statements could occur without detection. The auditors are not aware of any material weaknesses in the University's control environment at June 30, 2000. The second level of weakness is a reportable condition or significant deficiency in internal control. The auditors believe that at June 30 there were significant deficiencies in the control structure at the San Francisco medical center to merit reporting to The Regents.

In response to a question from Committee Chair Connerly regarding the new GASB pronouncements, Mr. Forrester explained that the major change is that the University will be required to depreciate its assets. PWC has been working with the Office of the President and the campuses in developing a practical and compliant approach to the depreciation of buildings, equipment, collections, and software. Under GASB Statement No. 35, the financial statements must be preceded by a Management's Discussion and Analysis section that will be similar to the current financial review. There are remaining conceptual issues with regard to GASB's prescribed treatment of State appropriations as a subsidy that covers a loss from other operating revenues rather than as a source of operating revenue. PWC will be working with the Office of the President, the University community, and the GASB on the resolution of these matters and, once the effect of applying the new principles to the University is clear, the Office of the President will discuss this effect with the Regents. The GASB also believes that Medi-Cal reimbursements could be considered as subsidies rather than fees for services provided by the University's hospitals. It is likely that GASB will hold hearings on this issue at which time there would be an opportunity to testify. He estimated that a decision on the State appropriations issue should be reached next year.

Regent Lee referred to Arthur Andersen's audit of the San Francisco medical center which was discussed by Director Laret at the November 15 meeting of the Committee on Health Services. Mr. Forrester reported his understanding that the current schedule calls for the report to be issued in the following week, at which time the USHC board would meet to accept the report. He continued that, under generally accepted accounting principles, any exposures would be integrated into the financial statements of the joint venture.

In response to a comment by Regent Parsky, Mr. Forrester expressed his intention to provide a full report on the management letter at the January meeting.

The Committee went into Closed Session at 2:55 p.m.

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The meeting adjourned at 3:10 p.m.

Attest:

Secretary