

The Regents of the University of California

**COMMITTEE ON AUDIT**

September 19, 2002

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

Members present: Regents Connerly, Hopkinson, Lee, Lozano, Moores, and Terrazas

In attendance: Regent Bustamante, Faculty Representatives Binion and Pitts, Secretary Trivette, General Counsel Holst, Treasurer Russ, Senior Vice Presidents Darling and Mullinix, Vice President Broome, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 2:00 p.m. with Committee Chair Terrazas presiding.

The Committee agreed to consider its action items prior to turning to the matters for discussion.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETINGS**

Upon motion duly made and seconded, the minutes of the meetings of May 15 and August 6, 2002 were approved.

2. **RESOLUTION CREATING STANDARDS FOR AUDIT AND NON-AUDIT SERVICES BY THE REGENTS' AUDITORS (THE "FIREWALL" PROPOSAL)**

It was recommended that The Regents adopt standards for audit and non-audit services by The Regents' external accounting firm. The Regents' external accounting firm shall be authorized to perform audit and audit-related services to the University. All "prohibited services," as defined in the Sarbanes-Oxley Act of 2002, will not be provided to the University by The Regents' external accounting firm. Other services may be performed by The Regents' external accounting firm only if they do not create the appearance of a conflict of interest, are competitively bid, and are approved by the Committee on Audit.

It was recalled that over the past several months there has been considerable national attention given to the services provided by external accounting firms to their clients and to the question of whether providing certain services may lead to the appearance of a lack of independence or conflict of interest. In addition, Congress and the Securities and Exchange Commission (SEC) have made significant changes to the regulatory framework over financial reporting for companies with publicly traded securities and how their audit committees, management, and auditors carry out their responsibilities.

The Sarbanes-Oxley Act of 2002, signed into law on June 30, 2002, specifically designates categories of services that external accounting firms may have formally provided their audit clients that are now designated as prohibited services. As a non-SEC entity, the University

is not subject to the provisions of the Sarbanes-Oxley Act, although audit committees of non-SEC entities are considering these provisions as best practices.

Because the University is a complex organization, it is generally in the University's best business interest to take advantage of The Regents' external accounting firm's knowledge of the institution to receive superior professional audit and accounting services. Thus, it is recommended that The Regents' external accounting firm be authorized to perform audit and audit-related services for the University. For purposes of this recommendation, audit-related services are deemed to be federal audit support, internal control reviews and investigations, implementation of new accounting standards, review of income and other tax matters, internal financial reviews, due diligence procedures related to public debt offerings, and other transactions and audits of affiliated entities or special purpose audits.

The Sarbanes-Oxley Act of 2002 lists eight categories of services that are unlawful for an external auditing firm to provide for companies with publicly traded securities. Those prohibited services include bookkeeping, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audits, management and human resource services, broker/dealer and investment banking services, and legal services. These services are not being performed, nor have they been performed in recent years for the University by The Regents' external accounting firm. The University would not retain The Regents' external accounting firm to provide such services.

In addition, it is recommended that the Vice President–Financial Management could permit The Regents' external accounting firm to competitively bid for services that do not create a conflict of interest or appearance of such a conflict and are allowable under the Sarbanes-Oxley Act, the General Accounting Office independence standards for audit, and the American Institute of Certified Public Accountants ethics standards. The Regents' external accounting firm would be retained to perform such services only upon the approval of the Committee on Audit.

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

3. **APPROVAL OF PROCESS FOR ENGAGEMENT OF THE REGENTS' AUDITORS BEGINNING IN FISCAL YEAR 2003**

It was recommended that the University evaluate the existing arrangement with The Regents' external accounting firm, PricewaterhouseCoopers (PwC), and if such evaluation determines that retention of PwC is in the best interests of the University, that the University be authorized to negotiate an extension of the existing contract.

It was recalled that during most of the University's history, The Regents had retained one national accounting firm for audit services. Since 1984, The Regents, with the assistance

of management, has conducted three Request for Proposals processes for the selection of an external auditor, with new firms being selected in 1984, 1995, and 1999.

Three of the four remaining national accounting firms have both the higher education and health care expertise required to provide service to the University. During the past eight years, the University has retained as its auditor all three of these firms. PricewaterhouseCoopers was selected as The Regents' external auditors in 1999 based upon a competitive bidding process. At that time, PwC was determined to offer the highest level of service at the most competitive price.

Under the terms of the California Public Contract Code, the services of the University's audit firm are not required to be competitively bid and may be negotiated. However, the cost must be determined to be reasonable. As part of the review of the existing arrangement with PwC, the administration has done or will do the following:

- Evaluate service and quality elements provided by PwC.
- Evaluate PwC's relationship with the Committee on Audit and with the Office of the President, the campuses, and the medical centers.
- Evaluate the national and regional industry expertise brought to the University by PwC.
- Evaluate the administrative costs involved in changing The Regents' external accounting firm.

If that review determines that continued retention of PwC would be in the best interests of the University, the University will negotiate with PwC the fees associated with an extension of the engagement for audit and audit-related services.

In response to a question from Committee Chair Terrazas, Vice President Broome confirmed that she had consulted with the campuses and the medical centers regarding the quality of services that had been provided by PricewaterhouseCoopers and that they are in favor of continuing to retain PwC as The Regents' external auditors.

Vice President Broome also confirmed for Regent Terrazas that the recommendations approved by the Committee would need to be presented to The Regents for action at its November meeting. It was the consensus of the Committee that, once the University's review of the service provided by PwC was complete, Vice President Broome should begin to negotiate the terms of the audit engagement.

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

4. **REVIEW OF BYLAW 12.1 AND CONSIDERATION OF SARBANES-OXLEY ACT REQUIREMENTS AND BEST PRACTICES STUDIES**

Senior Vice President Mullinix recalled that an analysis of the Sarbanes-Oxley Act that had been prepared for the University by PricewaterhouseCoopers had been distributed to the Committee in advance of the meeting. He observed that it was common for audit committees to adopt a charter to define their responsibilities and suggested that it would be appropriate for The Regents to adopt such a charter for the Committee on Audit.

Regent Hopkinson suggested the need for a review of the audit function that would include the Committee's charter as well as the reporting relationships within internal audit. Committee Chair Terrazas recalled her suggestion during the Committee's August 6 meeting that the University consider the retention of an outside consultant to assist in this review process. Regent Hopkinson believed that there were a number of firms in northern California with the expertise to perform this work for the University. It was her understanding that Senior Vice President Mullinix's office would be asked to issue a Request for Proposals for this work. The RFP should be circulated to the members of the Committee.

Regent Lozano supported the idea of an outside review, noting that the purpose of such a review would be to identify best practices and to make sure that the Committee's charter reflects them.

University Auditor Reed commented that the scope of the review could include elements of a peer review of the internal audit function. It would be in the best interests of the internal audit program to ensure that the firm that is selected has the expertise to perform this peer review.

Regent Hopkinson pointed out that it would be difficult to mold the requirements of the Sarbanes-Oxley legislation to the Committee on Audit. Senior Vice President Mullinix suggested that the Committee may wish to consider the appointment of an outside advisory member who was a Certified Public Accountant. Regent Hopkinson believed that the consultant should also be asked to look into this issue. Mr. Mullinix stated that at the November meeting he would present a summary of the issues for the consultant.

Committee Chair Terrazas observed that both the University Auditor and The Regents' external auditors may be called upon to provide professional advice to the Committee. He did not believe that it would also be necessary to have a CPA.

## 5. **UPDATE ON 2002 ANNUAL AUDIT**

Vice President Broome introduced Mr. Mike Schini and Ms. Elaine Garvey of PricewaterhouseCoopers, noting that Mr. Schini is the managing partner of the engagement. Mr. Schini reported that PwC is in the process of completing the field work for the external audit. There are no unexpected findings to report. He recalled that significant changes with respect to reporting are being implemented this year by the Governmental Accounting Standards Board, which was a major focus of the audit. The audit work at the campuses and

medical centers is complete; the financial statements now need to be consolidated. There is nothing that should prevent PwC from presenting its annual report to the Committee at the November meeting.

Regent Lee asked whether the auditors had any suggestions for the University of California as a result of their work for other universities. Mr. Schini agreed to include some information in his report to the Committee in November.

**6. DISCLOSURE OF NEW NON-AUDIT SERVICES AT UC BY PRICEWATERHOUSECOOPERS**

Vice President Broome informed the Committee that there were no non-audit services being performed by PricewaterhouseCoopers for the University other than those she had reported to the Committee at its March meeting. She distributed a chart showing audit and consulting fees paid to PwC in 2000, 2001, and 2002 and the ratio of consulting to core audits during that time. She reported that the \$2.6 million paid to the firm in 2002 for consulting services were associated with three projects: the replacement study for the Irvine medical center, a rate-sensitivity analysis for the UCLA medical center, and the finalization of work performed for the Los Alamos National Laboratory. Vice President Broome reported that PricewaterhouseCoopers had sold its consulting division, although some of the consulting work will remain within PwC. Future consulting work must be competitively bid and approved by the Committee.

Senior Vice President Mullinix continued that the Office of the President had recently notified the medical centers of new procedures which require them to notify the Office of the President prior to retaining PwC for any consulting engagement. New guidelines will take into account the requirement for competitive bidding.

Regent Hopkinson raised the issue of pending legislation before the Governor which could prohibit the University from retaining a firm for certain services. Mr. Mullinix reported that, if the legislation is signed by the Governor, it will go into effect on July 1, 2003. It was his understanding that amendments to the legislation would be offered as an emergency measure in December. Some of the restrictions in the areas of construction and architecture would be particularly onerous for the University. Senior Vice President Mullinix believed that it may be possible to define the scope of work in a way that would be permissible under the law.

**7. REVIEW OF ACTIVITIES REPORT FOR QUARTER ENDED JUNE 30, 2002**

University Auditor Reed provided highlights of the report for the quarter ended June 30, 2002, noting that the downturn in the economy had resulted in an average staff level which continued to run slightly above the plan for the year, with an increase of six staff members

over the prior year. In addition, there was increased use of contract labor and interns. As a result, there were 7,500 more available audit hours than planned and 17,000 more hours than the year before. The additional available hours, together with the continued reduction in investigation time, allowed for 12,000 more hours devoted to audits than were anticipated in the audit plan. The hours devoted to advisory service projects exceeded investigation hours by 85 percent. Mr. Reed reported that the University's whistleblower and retaliation policies had been issued for final review and should be released in final form in the near future. During the quarter, two laboratory directors participated in an external national laboratory peer review, and two campuses underwent internal quality assurance reviews.

In response to a question from Regent Terrazas, University Auditor Reed commented that it is difficult to predict the amount of time that will be necessary to devote to investigations because unforeseen special circumstances may arise. The internal audit departments are more available to their constituents when they are not overwhelmed by investigations.

Continuing with his presentation, Mr. Reed reported that a two-day auditors' meeting was held to communicate results of strategic initiatives, emerging issues, and audit program concerns. This meeting resulted from the desire to increase collaboration and communication among the campus internal audit programs. The Bureau of State Audits review of the partnership agreement was issued shortly after the end of the quarter. Internal audit spent considerable effort leading the systemwide coordination of this nine-month audit. He concluded by noting that the annual report will provide greater detail on the completion of the audit plan.

Regent Lee raised the issue of the University Auditor's reporting relationships. Mr. Reed explained that functionally he reports to The Regents, while administratively he reports to the Senior Vice President—Business and Finance through delegation from the President. Following some discussion of what information should be provided by the auditor to the Committee, Committee Chair Terrazas suggested that it would be appropriate for University Auditor Reed to provide the chair with highlights of the reports that he presents to Senior Vice President Mullinix during the course of the year. Mr. Reed reported that the internal audit departments were in the process of establishing a database in order to identify emerging issues and common findings that arise during the course of their work. These conclusions will be shared with the Committee.

Regent Hopkinson asked that at a future meeting there be a discussion of how an audit investigation takes place and the length of time that is required.

## 8. **STATUS REPORT ON OPEN INVESTIGATIONS**

University Auditor Reed recalled that Committee Chair Terrazas had requested a status report on open investigations. He reported that as of June 30, 2002 there were 56 open investigations of matters that required reporting to the Office of the President. The number of open investigations is slightly higher than normal due to administrative delays in closing.

Mr. Reed commented on three open investigations that had been previously reported to the Regents. He recalled that in late May 2002 the President had written to the Board regarding the apparent theft of BART tickets at the Berkeley campus. The investigation has been closed, with the final loss determined to be \$261,000. One employee and three outsiders involved in the distribution of the tickets have been arrested, and the employee has been terminated.

A second investigation relates to the use of procurement cards at the Los Alamos National Laboratory. The August communication to the Regents described the formation of a high-level review team; a final report is expected by the end of the calendar year.

In response to a question from Regent Terrazas, University Auditor Reed confirmed that audit work is performed at the national laboratories by KPMG, with the scope varying from year to year. The internal auditors at the national laboratories do not have any direct responsibility for security at those facilities.

Mr. Reed continued with an update on the investigation at the Equine Center at the Davis campus, where an employee has been arrested in connection with records falsification related to the disposal of horses. The employee is on leave pending completion of the investigation.

Regent Connerly asked that there be scheduled a closed session of the Committee in November in order to go into these issues in more detail, given the fact that they involve personnel matters.

Mr. Reed presented a table that detailed the categories of investigations that had taken place from 1999 to 2002 at the level of the Office of the President. He noted that a similar number of more minor investigations take place at the campus level. The categories "Theft Fraud" and "Theft Non-Fraud" account for approximately half of the total of 237 investigations. He explained that fraud implies an element of deception. An additional type of investigation involves the alleged misuse of time, such as the conduct of personal business on University time or the misuse of computers. In response to a previous comment by Regent Hopkinson, he observed that there is an element of ethics involved in all categories of investigation. Allegations that involve activities such as sexual harassment or discrimination, however, are the responsibility of the human resources department rather than internal audit. He referred to the Faculty Code of Conduct as a policy on how employees are expected to perform. In addition, the health sciences compliance program contains a statement on ethics. There is no Universitywide ethics statement, but the violation of a University policy could become an improper governmental act. Any allegations reported to management undergo a triage by which they are assigned to the proper investigative agency.

General Counsel Holst commented that the University has an appropriate methodology in place with respect to the investigation of claims and stated his intention to assemble a flow chart describing the various activities and their sources. Regent Lozano asked that the chart include which activities are reported to the Regents through which Committee.

University Auditor Reed commented that some allegations may contain various elements which need to be reviewed by more than one department. Regent Hopkinson pointed out that the Regents do not necessarily receive information on matters which are not investigated by internal audit.

In concluding his presentation on open investigations, Mr. Reed presented a table which provided details on the percentage of allegations that were sustained during the 1999 to 2002. Charges reported by the UC police are sustained 100 percent of the time, while those reported by whistleblowers are correct about half of the time. Anonymous whistleblower complaints are the least likely to be true, and not all of these complaints are investigated.

In response to a question from Regent Hopkinson, University Auditor Reed confirmed that the campuses report allegations to the Office of the President that meet certain monetary and other conditions. The threshold for reporting to the University Auditor is an allegation that involves more than \$1,000, while the threshold for management's reporting to Senior Vice President Mullinix is \$25,000. These written reports are provided to the administration by the vice chancellors. The campuses have an obligation to keep the Office of the President informed about matters that should be reported to the Regents.

9. **REPORT ON PRIOR EXTERNAL REVIEWS OF INTERNAL AUDIT PROGRAMS:  
1998 AND 2001 REPORTS AND BENCHMARK COMPARISONS**

University Auditor Reed recalled that an external review of the internal audit function had been performed in 1998 at the request of the Committee on Audit. The review, which was conducted by a panel of external experts with various backgrounds and perspectives, analyzed internal audit program activities for compliance with professional audit standards. The panel also interviewed members of the University community, including Regents, the President, vice presidents, and all audit directors. The panel found that the University had a sound internal audit program; the dual reporting and decentralized structure appeared to be appropriate to the University's overall organizational structure. The panel made the following recommendations for enhancement to the internal audit program; these recommendations formed the basis for strategic planning within internal audit:

- Raise knowledge sharing and teamwork to the next level.
- Formally prioritize key initiatives, assign responsibilities, and measure progress.
- Further enhance the risk assessment process and methodology.
- Clarify, support, and help facilitate the controller function and control self assessment.
- Further refine roles and responsibilities of local audit committees.
- Identify and develop individuals with specialized skills.

University Auditor Reed continued that as a result of the 2001 follow-up review, the panel was satisfied that progress on the recommendations had been adequate during the



intervening period and recommended that there be continued progress on the six original recommendations. The report also observed that the panel continued to not advocate any form of single audit function for the University, believing that the individual campus and laboratory audit functions should not be fundamentally changed.

Mr. Reed discussed two benchmark studies that had been performed, the first being the 2001 KPMG University systems study, in which eight systems participated. This study found that, in general, the internal audit director reports to executive management. He observed that his oversight of the campus internal audit departments is more direct than that of most of his peers in higher education systems. In addition, the KPMG study found that 43 percent of the internal audit departments report functionally to the Audit Committee, with the balance reporting functionally to management. They report administratively to executive level management.

University Auditor Reed commented on the 2002 Institute of Internal Auditors GAIN study, which had 789 respondents from all industries. For respondents with assets of \$20 billion or more, one finding was that 55 percent of internal audit departments report functionally to the Audit Committee and 33 percent report to management, while administratively the majority report to a senior officer. Mr. Reed presented data regarding reporting, noting that 90 percent of respondents provide management with draft reports for review and include their responses in the final report.

Regent Connerly expressed concern that internal audit departments would change their findings based upon management's response. University Auditor Reed acknowledged that this was a fair concern. Regent Connerly believed that a more appropriate practice would be to include the draft findings with the final report, while also showing management's response.

Mr. Reed noted that the internal audit department's working papers contain all of the documents that are relevant to an audit review. The internal auditors recognize the need to reconcile the original report with the audit that is released. There is no guarantee that the auditors will draw all of the right conclusions in a first draft. He believed that any external auditor would agree with the view that the inclusion of a draft in the final audit document would prove to be awkward. Mr. Reed agreed, however, that the internal auditors need to be held accountable for any changes that are made in the final report.

Regent Connerly continued to believe that if the internal auditors change their findings in response to objections from management, that fact should be disclosed.

Regent Hopkinson shared Regent Connerly's belief that a paper trail should exist to demonstrate what changes are made to a draft audit report. Another important issue is who sees the report and when, especially given the fact that individuals who are the subject of the audit are provided with a copy of the draft report. She suggested that the outside review

discussed by the Committee should assist the Regents in understanding that the current process is the correct one.

10. **THE AUDIT PROGRAM, STRUCTURE, REPORTING, POLICIES, AND LESSONS LEARNED FROM RECENT INVESTIGATIONS**

University Auditor Reed invited the Committee members to comment on any issues that might be appropriate to include in the RFP for the external review. Committee Chair Terrazas stressed that the review should address the concerns that were raised by Regent Connerly.

In response to a comment by Regent Lee, General Counsel Holst recalled that the Committee is provided the opportunity to meet in Closed Session to discuss personnel issues, litigation, and other confidential matters. It has been the historical practice of the Committee to meet privately with the external auditors on an annual basis for the purpose of discussing personnel issues with no administrative officers present.

Regent Connerly reiterated the fact that the Committee would have no way of knowing whether or not significant changes had been made to an audit report as a result of pressures from management. He believed that it was important for the Committee to have this information.

University Auditor Reed stressed that the internal audit departments frequently make significant changes to their reports. The crucial issue is whether or not the changes were imposed by management. Regent Hopkinson saw the need for an independent voice at the campus level. Mr. Reed pointed out the need to trust the people who perform the audit work at the campus level. Regent Hopkinson believed that the issue relates to human nature rather than trust.

11. **PREVIEW OF THE UNIVERSITY'S 60-DAY RESPONSE LETTER TO THE BUREAU OF STATE AUDITS**

University Auditor Reed recalled that he had been asked to provide an update on the ongoing response to the recommendations contained in the July 25 Bureau of State Audits report on the University's Partnership Agreement with the Governor. The letter will reiterate the University's agreements with the recommendations contained in the report and reconfirm the intent to act upon all of them. He noted that the recommendations fall into two basic categories: that of the Partnership Agreement itself, and the use of funds for administration. The more specific recommendations in the audit referred to instructional activities such as faculty work load. The response will explain that staff within the Office of the President are studying the University's definition of a course in order to respond to the BSA findings. In addition, the response letter will report the formation of a Universitywide task force on faculty instructional activities which will concentrate on undergraduate education in a research setting. The letter will reconfirm the University's commitment to 1,000 freshman

seminars and discuss progress to date. Mr. Reed stated his intention to provide a copy of the response letter to the members of the Committee.

12. **UPDATE ON NEW OR OPEN AUDITS AND INVESTIGATIONS**

University Auditor Reed reported that the United States Department of Agriculture had conducted an audit at the Davis campus as part of a nationwide review of toxic chemicals and biochemical wastes. The USDA identified a number of best practices being used by the campus.

13. **PRICEWATERHOUSECOOPERS REPORT ON WHISTLEBLOWER ISSUE**

Committee Chair Terrazas explained that PricewaterhouseCoopers had been approached by a University employee who alleged that the University was engaged in fraud with respect to the charging of graduate student tuition remission to federal awards. The employee, who requested anonymity, has asserted that this practice is not allowable. Similar allegations were made several years ago, and the General Accounting Office issued a report in June 1999 that did not draw a clear conclusion on the allowability of the University's practices or whether students must be taxed. Since the conclusion of the GAO audit, PwC has been informed that there has been no communication from HHS to question the practice of charging tuition remission to federal grants, nor has there been any communication from the Internal Revenue Service relevant to tax matters. Further, an audit by HHS of six campuses related to tuition remission did not reveal any unallowable costs. However, the National Institutes of Health continue to issue guidance as to what it considers to be reasonable compensation, and amounts charged by the University sometimes exceed the NIH guidelines. As a result of these allegations, PwC met with the employee and with management and reviewed relevant correspondence. PricewaterhouseCoopers is in the process of reviewing all aspects of the whistleblower complaint; to date, the external auditors do not believe that the University's charging of tuition remission and its tax treatment is inappropriate. PwC's ultimate findings will be shared with the Committee.

General Counsel Holst added that there are extensive legal files with respect to the False Claims Act suit brought by the whistleblower. The Department of Justice declined to accept that claim, and the suit has been dismissed.

The meeting adjourned 3:45 p.m.

Attest:

Secretary