The Regents of the University of California

COMMITTEE ON AUDIT
November 19, 2003

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

Members present: Regents Bodine, Connerly, Davies, Hopkinson, Lozano, and Moores; Advisory member Pitts

In attendance: Regent Huerta, Secretary Trivette, General Counsel Holst, Senior Vice President Mullinix, Vice President Broome, Laboratory Director Shank, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 4:20 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 September 17, 2003 were approved.

2. **ANNUAL REPORT OF THE EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2003**

In accordance with the Schedule of Reports, the Annual Report of External Auditors for the Year Ended June 30, 2003 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.]

It was recalled that the objective of The Regents' external auditors in performing the basic University audit is to render an opinion on the 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 Required Communications to the Board of Regents was prepared by PricewaterhouseCoopers LLP (PwC), external auditors of The Regents. The Management Letter contains the auditors' observations and recommendations.

Vice President Broome introduced the PwC representatives: Mr. Mike Schini, the engagement partner, and Mr. Gary Garbrecht, the medical center partner. Mr. Schini highlighted some elements of the annual report, noting that in the course of the audit PwC is required to communicate its views on changes in accounting policies as well as any unusual transactions related to the financial statements. During the year ended June 30, 2003, the University did not change any accounting policies of significance. Mr. Schini called attention to an unusual transaction, the receipt by the San Francisco campus of a gift of 17 acres of land valued at $26 million, from a development company and the City of San

Francisco pursuant to agreements reached between the parties in 1998 related to the Mission Bay campus site. The developer's current and previous gifts supported part of an exchange for State public trust claims on nearly 100 acres of its land, enhanced the value of its surrounding property, and allowed the developer to take a charitable deduction. The University is not obligated to conduct any business with this developer. Mr. Schini confirmed for Committee Chair Connerly that there had been nothing untoward about the transaction.

Mr. Schini reported that the external auditors had reviewed the process the University uses in developing accounting estimates and believes that the process is reasonable. Any estimates, however carefully developed, may differ materially from actual results. Some of the more significant estimates inherent in the financial statements, together with their related amounts at June 30, 2003, include the following:

- Self-insurance reserves of $520 million
- Reserves for bad debts of $204 million
- Reserves for medical center third-party payor settlement liabilities of $134 million
- Carrying values of certain private investments: $1,078 million

Mr. Garbrecht addressed the issues posed by the medical centers' third-party payor settlement liabilities. Each medical center has contracts with Medi-Cal and Medicare programs for reimbursement of health care services. The medical centers submit a statement of reimbursable costs, and this statement is subject to an outside audit. Because of this outside audit and the fact that the rules are subject to interpretation, Mr. Garbrecht believed that the reserve had a higher degree of uncertainty than a normal estimate would.

Mr. Schini reported that there were no instances of fraud or illegal acts which were detected through the audit. The University has established policies and processes governing the reporting of allegations and instances of misuse of University resources. Any matter of significance is required to be reported by internal audit to the Committee. With respect to difficulties encountered in performing the audit, Mr. Schini recalled that the Committee had been informed of difficulties in connection with completing audit procedures at the Lawrence Berkeley National Laboratory. PwC also encountered certain difficulties in completing its audit procedures at one location due to personnel matters. Neither of these issues caused an undue delay in the completion and publication of the University's financial statements. He continued that the external auditors are required to communicate any significant audit adjustments that were proposed to management but not recorded in the preparation of the financial statements. Mr. Schini reported that management had recorded all significant proposed adjustments.

Mr. Schini noted that the management letter represents a compendium of the most significant comments that were issued by PricewaterhouseCoopers to management at the campuses, medical centers, and Department of Energy Laboratories. None of the items discussed in the letter would be deemed to be material weaknesses related to the internal control structure.

Mr. Schini highlighted some of these comments, beginning with the recommendation that the University consider the development of a build-up certification process. He recalled that, as a result of the passage of the Sarbanes-Oxley legislation, many companies have made changes intended to strengthen their closing processes to ensure that there is appropriate support for the quarterly and annual certification of financial information provided to the Securities and Exchange Commission. While the University is not subject to Sarbanes-Oxley, the Office of the President has begun to introduce a build-up certification process that requires that the campuses and medical centers provide a copy of the annual representation letter to the external auditors to the Office of the President as support for the assertions made in the University's overall representation letter. Use of a build-up certification process will assist in demonstrating due diligence by the signatory of any representation letter than he or she has a basis to make the representation and also emphasizes the importance of the accuracy of information provided in connection with the closing process to others in the organization. Management concurs with the recommendation that all campuses give consideration to requiring build-up certification as a basis for signing the campus representation letter.

Mr. Garbrecht commented on the observations presented in the management letter with respect to third-party settlement accounting documentation standards. As noted above, as a provision for participating in Medi-Cal and Medicare programs, the medical centers are subject to the rules and regulations promulgated by the Centers for Medicaid and Medicare (CMS), including the requirement to file annual cost reports. These reports are audited by a third-party fiscal intermediary contracted by the CMS; the intermediary for the University of California is United Government Services (UGS). These audits by UGS have resulted in asserted, proposed, or final adjustments with both retrospective and prospective financial and reimbursement implications. To the extent that such adjustments are asserted, proposed, or finalized, management evaluates the need to accrue loss contingencies. As a result of these asserted claims, the medical centers have recorded significant loss contingencies. The documentation maintained by the medical centers should be supportive of the accruals made while not compromising the medical centers' legal and contractual rights. As such, legal counsel is often involved in reviewing documentation and positions taken in these matters. PricewaterhouseCoopers has recommended to the medical centers that they consider involving counsel to advise them on the review, development, and implementation of formal policies and procedures that would provide consistent guidance on the implementation, development, and recording of loss contingencies associated with the cost reporting process. University management and the Office of the General Counsel concur.

Mr. Garbrecht reported that PwC has also recommended to certain of the medical centers that they take steps to improve their capital asset physical inventories. Three medical centers–UCLA, UCSF, and UCD–should consider performing an independent physical inventory either through the engagement of a consultant or through internal resources. Each of the medical centers recognizes the importance of maintaining strict inventory control and has agreed to emphasize procedures to increase the integrity of the process.

Mr. Schini summarized the comments that had been made pertaining the Lawrence Berkeley National Laboratory, the Lawrence Livermore National Laboratory, and the Los Alamos National Laboratory. He recalled that the scope of the work had been broadened to encompass the reporting by the three laboratories to the Department of Energy. The assets and liabilities of the laboratories are not consolidated within the University's balance sheet but they are reported to the DOE. Due to the relatively small size of the individual laboratories' operations, DOE's external auditors tend not to look carefully at their balance sheets. PwC undertook the responsibility of ensuring that accounts were being reconciled at the laboratories. As previously reported to the Committee, the external auditors noted that monthly reconciliations were not being performed at the Berkeley laboratory. Corrective action is under way to bring these reconciliations up to date. Mr. Schini commented that management at all three laboratories were taking the management letter recommendations seriously, and improvements were being made.

In response to a comment by Regent Hopkinson, Mr. Schini concurred that PricewaterhouseCoopers would be prepared to conduct audits at the laboratories if requested to do so. Vice President Broome stated the intention to recommend to the Committee both the scope and the cost of such an audit for the year ending June 30, 2004.

Regent Hopkinson referred to the statement in the management letter that inventory accounts relating to weapons production at the Los Alamos National Laboratory have not been tracked accurately since approximately 1999. Mr. Schini recalled that, of the total weapons inventory of $417 million, approximately $53 million had not been tracked; this matter has been reported to the Department of Energy. The laboratory has completed an initial review of the weapons production area and has adjusted its general ledger accordingly. Regent Hopkinson asked that this point be verified by the external auditors.

A final issue addresses the reconciliation of payroll and benefit accounts at the Berkeley campus, which had not been kept up to date. Berkeley campus management concurs with the recommendation that payroll and benefit accounts be reconciled to the general ledger and reviewed on a monthly basis.

3. **AMENDMENT OF BYLAW 12.1 - COMMITTEE ON AUDIT, TO PROPOSE A REVISED COMMITTEE CHARTER**

The President recommended that following service of appropriate notice, Bylaw 12.1 - Committee on Audit be amended as indicated below to revise the Committee's charter.

Deletions shown by strikeout, additions by underlining

BYLAW 12.

RESPONSIBILITIES OF STANDING COMMITTEES

12.1 Committee on Audit.

The Committee on Audit shall:

(a) ~~Exercise supervision over post-auditing activities related to the conduct and administration of the University.~~
Advise the Board of Regents in connection with the Board's responsibilities relating to the quality and integrity of the University's financial reporting, compliance with legal and regulatory requirements, systems of internal control and risk mitigation, the independent certified public accountant's qualifications and independence, and the performance of internal audit and the independent certified public accountant.

(b) ~~Transmit to the President of the University, subject to the prior approval of the Board, such instructions as it deems necessary for the enforcement of sound accounting and auditing practices.~~
Meet at least four times a year.

(c) ~~Recommend to the Board a firm of independent certified public accountants which shall audit the financial statements of the Corporation and of the University on an annual basis in accordance with generally accepted auditing standards and make such studies as shall be authorized by the Committee for the information of the Board.~~
Monitor the University's system of internal control and the adequacy of accounting, financial, and operational policies and practices on financial and significant compliance reporting.

(d) ~~Act in an advisory capacity to the President of the University with respect to appointment of the University Auditor.~~
Review the annual internal audit plan and discuss the extent to which it addresses high risk areas with the University Auditor and management.

(e) Review the annual report on the accomplishments of the internal audit department and discuss significant issues of internal control and compliance with the University Auditor and management.

(f) Discuss the planned scope of the annual independent audit and other engagements with the independent certified public accountants and review the results of the audit and other engagements with the independent certified public accountants and management.

(g) Receive and review the annual financial report with the independent certified public accountants and management.

(h) After considering the recommendations of management, recommend to the Board the certified public accountants to serve as independent auditor and pre-approve any services provided by the certified public accountants.

(i) Have the power, through its Chair, to request management to address specific issues within the mandate of the Committee and have the authority to engage independent counsel and other advisors to carry out its duties.

Vice President Broome suggested the need to amend slightly the recommendation contained in paragraph (h) to add the word "consulting" to "...any services provided by the certified public accountants." She recalled that in 2002 the Committee had approved the scope of services to be performed by the external auditors. Any consulting services must be first deemed to be appropriate and must be secured through a bidding process.

Regent Hopkinson was concerned that reporting relationships were not addressed in the proposed amendment of Bylaw 12.1. It was noted that The Regents' external auditors are hired by and report to the Board, while the University Auditor - internal audit function - reports jointly to The Regents and the President.

University Auditor Reed recalled that in 1995 The Regents had approved an internal audit mission statement that speaks to the these issues and offered to share the document with the Regents.

It was the sense of the Committee that the proposal should be further modified and brought back for action at the January 2004 meeting.

4. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2002-03**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Activities 2002-03** 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 recalled that the Committee had commissioned a review of various aspects of the University's audit activities by the consulting firm Protiviti; the Protiviti report was presented to the Committee at its March 2003 meeting. At that time, Committee members expressed an interest in having more interaction with the campus internal audit staff. He noted that, as a result, all of the campus and laboratory internal audit directors were in attendance at today's meeting.

Mr. Reed drew the Committee's attention to the events that had occurred at the Los Alamos National Laboratory over the past year as they had affected the annual internal audit report in a variety of ways. As a result of changes in the laboratory's reporting structure, significantly more employees – those engaged in investigations and sub-contract auditing – are included in the report for the first time. These activities were not included in the plan for the current year. Accordingly, comparisons to both the plan for fiscal year 2003 and the prior year produce variances which are principally the result of this reporting change. Systemwide audit staff declined slightly as a result of positions being left open because of budget conditions. Mr. Reed anticipated that the problem would worsen in the future. The events at Los Alamos created an opportunity for the auditors to learn about the importance of their being independent from management with regard to timely reporting and timely follow-up on open investigations. He continued that, for most of winter 2002, a number of managers and directors from internal audit in the Office of the President were transferred to work at Los Alamos; considerable assistance was provided by the Lawrence Livermore National Laboratory. An offer of employment has been made to a candidate from the Inspector General's Office of the Department of Energy for the position of director for the Los Alamos internal audit department. University Auditor Reed stated his commitment to strengthening the internal audit program at Los Alamos.

University Auditor Reed highlighted the following conclusions that were presented in the annual report, likening them to the required communications that are provided by the external auditors:

- Management of the University is cognizant of its responsibility for internal controls and takes seriously the need for controls and accountability.

- There is respect for the objectives of the internal audit program; a high level of cooperation is received and there is no interference with either the accomplishment of tasks or responsibilities to report to The Regents.

- Managers actively participate in the identification of risks and work collaboratively with internal auditors to address issues raised during audits and investigations.

- To a growing extent, managers seek out internal audit for advice and consultation on matters with internal control implications.

- Matters of importance are reported to The Regents.

Regent Connerly asked whether the budget situation could impede internal audit's ability to carry out its responsibilities. Mr. Reed believed that management's decision on several campuses to protect the internal audit function from budget cuts to date had enabled the program to hold its own in terms of staffing. He observed, however, that controls tend to deteriorate in difficult economic times due to the loss of staff. In addition, the pressure to achieve programmatic objectives puts pressure on staff to cut corners, and this results in increased time devoted to investigations. For example, there was a 35 percent increase in investigation hours in fiscal year 2003, compared with a budgeted increase of 28 percent, which was based upon the knowledge that the budget situation would begin to put pressure on this area of activity.

5. **ANNUAL REPORT ON HEALTH SCIENCES CLINICAL ENTERPRISE CORPORATE COMPLIANCE**

The Committee was informed that in order to provide accountability to the Board of Regents, the members of the University's Systemwide Health Sciences Clinical Enterprise Corporate Compliance Committee (Compliance Committee), in coordination with the Office of Business and Finance, the University Auditor, and the Office of the General Counsel, have developed a process for annual reporting to their respective academic health center executive leadership and campus chancellors, as required by the system Compliance Program and The Regents. The reporting process also requires that each campus Compliance Officer submit an Annual Report to the Office of the President/Senior Vice President for Business and Finance. The Compliance Committee has undertaken a review of each of the five campus reports. The outcome of that review process serves as the basis for this Health Sciences Clinical Enterprise Corporate Compliance Annual Report to the Board of Regents.

Senior Vice President Mullinix commented that the report had revealed a variation among the campuses as to how they focus on the elements of the compliance program. The Office of the President has begun a process to ensure that there are consistent standards of compliance and to see that best practices are communicated throughout the system.

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

The Committee went into Closed Session–Regents Only at 4:55 p.m.

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The meeting adjourned at 5:25 p.m.

Attest:

Secretary