

The Regents of the University of California

COMMITTEE ON AUDIT

March 13, 2003

The Committee on Audit met on the above date at De Neve Plaza, Los Angeles campus.

Members present: Regents Hopkinson, Lee, and Terrazas; Advisory member Binion

In attendance: Associate Secretary Shaw, General Counsel Holst, Senior Vice President Mullinix, Vice President Broome, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 10:31 a.m. with Committee Chair Terrazas presiding. Due to the lack of a quorum, the meeting was held as a briefing session for those Regents in attendance. It was noted that directors of internal audit from the campuses and laboratories were in attendance.

1. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2003**

It was recommended that the annual audit plan for the year ending June 30, 2003 be approved.

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

It was recalled that the annual external audit plan of The Regents' auditor provides for a financial audit of the University of California, including the University of California Retirement System. Additional audit coverage by the external auditor includes the National Collegiate Athletic Association (NCAA) audits, the Revenue Bond Indenture audits, audits of the five individual medical centers, audit procedures at the national laboratories, and the federal grants and contracts (A-133) audits.

At the November 2002 meeting, The Regents approved the appointment of PricewaterhouseCoopers LLP (PwC) as external auditor for the three-year period beginning with the fiscal year ending June 30, 2003. Also at that meeting, The Regents approved the total cost of the audit for the fiscal year ending June 30, 2003 of \$2,269,100, including out-of-pocket expenses of \$211,000, subject to appropriate adjustments for any future changes in the scope of work. Scope changes for 2003 are required due to the issuance of a new auditing standard and to an expansion of work at the three national laboratories.

Committee Chair Terrazas introduced the audit team from PricewaterhouseCoopers: Mr. Mike Schini, the engagement partner; Mr. Gary Garbrecht, the medical center partner; and Mr. Rick Wentzel, the senior manager for the audit. Mr. Schini recalled that during the year ended June 30, 2002, the University made significant changes to its external financial reporting to conform with the requirements of new Governmental Accounting Standards

Board (GASB) Statements Nos. 34, 35, and 38. Adoption of these Statements, which required significant incremental effort, dramatically changed how the University's financial statements present the financial position and results of operations. In the current year, there are no new standards required to be implemented by the University; however, the University will begin the process of preparing for GASB No. 39, "Determining Whether Certain Organizations Are Component Units." When adopted, this standard will require the inclusion of the University's independent foundations in its financial statements as a discretely presented component unit. While not resulting in a traditional consolidation of the foundation results, the discrete display will necessitate additional effort by the University to determine the appropriate presentation of the foundations' financial position, changes in net assets, and cash flows. The Standard does not require conformity of the reporting of the foundations with that of the University. Mr. Schini stated his intention to work with the University and the foundations to review the discrete presentation for the year ending June 30, 2003 as these data will be needed for comparative purposes upon implementation.

In late 2002, the American Institute of Certified Public Accountants issued Statement on Auditing Standards No. 99 (SAS 99), "Consideration of Fraud in a Financial Statement Audit." The effect of this new Standard is that the auditors are required to have expanded discussions with various members of management regarding the existence and possibility of fraud and to be more alert to the possibility of fraud occurring. The Standard requires that these inquiries be made to the Audit Committee as well. Under the Standard, auditors will need to include an element of unpredictability in their procedures and not just perform the same procedures as in the prior year. SAS 99 reconfirms the auditor's responsibility to design the audit to provide reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, absolute assurance is not attainable, and even a properly planned and performed audit may not detect a material misstatement from fraud. Moreover, the auditor's responsibility relates to those items which are material to the financial statements.

Mr. Wentzel reported that PwC did not anticipate the current year to have many far-reaching changes with respect to federal regulations, but rather modifications and clarifications to existing ones. Certain agencies of the federal government, however, have voiced concerns about the quality of audits conducted under OMB A-133. In general there is a perception by some that the audits are not addressing the issues which are relevant. It is not yet known whether these concerns will lead to regulatory changes, but PwC will monitor the situation and inform The Regents of any changes that arise.

Mr. Garbrecht commented that, in the healthcare area, the University continues to expend resources and efforts to assist the medical centers to achieve appropriate operating results. The issues faced by the medical centers are not unique to the University and are reflective of both industry issues and healthcare trends in California. From an audit standpoint, PwC plans to continue close communication between the campuses and medical centers' audit teams to understand how these business issues are considered in the audit of the financial statements. PwC will also consider the potential effects of these issues on the consolidated

financial statements of the University. Another issue to be addressed is ongoing construction at the medical centers. Due to the downturn in the State's economy, a close eye will need to be kept on MediCal funding to ensure that any changes are appropriately reflected in the hospitals' reserve levels and receivables balances.

Mr. Schini commented on the national laboratories, noting that the Los Alamos National Laboratory continues to make changes in its organizational structure and processes to address the concerns raised by employees and investigators. As the Committee is aware, PwC has assisted with the investigations concerning Purchase-card (P-card) misuses and has extended the review to the entire procurement system. There are also investigations and studies currently being undertaken or planned by regulatory oversight bodies as well as other consultants engaged by the University. Although the matters raised to date are not material from a financial statement reporting standpoint, they are of concern due to the stewardship expectations coupled with spending any federal funds. As a result, PwC will reassess the scope of its audit procedures at Los Alamos and the other laboratories. Mr. Schini stated that, in connection with current-year planning, the auditors will update the status of the work performed in connection with the investigations, determine what additional testing should be considered, and report back to the Committee in May. As a result of the recent issues at Los Alamos, the University has begun to review processes and controls at Lawrence Berkeley and Lawrence Livermore National Laboratories. Similar to the approach for Los Alamos, PwC will consider the incremental testing needed and report back to the Committee at its May meeting.

Mr. Schini reported that the current-year audit plan, which builds upon PwC's knowledge of the University, is focused on concentrating on the areas of greatest risk from a financial statement viewpoint. The more significant areas of audit risk considered in the audit plan continue to include sponsored research, investments, and the medical centers, as well as the decentralized nature of the University's operations. Although there are fewer regulatory and industry-specific changes in these areas during the current year as compared to past years, sponsored research, State funding, and investments continue to have the most significant impact on the University's financial statements.

In concluding his remarks, Mr. Schini reported that, since the adoption of new standards for audit and non-audit services by the external auditors, no consulting services had been undertaken by PricewaterhouseCoopers on behalf of the University. Regent Terrazas drew attention to the dramatic decrease in consulting fees, down from \$2.6 million in 2002 to \$28,500 in 2003.

Regent Hopkinson expressed concern about the independence of the information provided to the external auditors by management, especially in connection with the issue of fraud and the protection of individuals who might communicate such alleged fraud to the external auditors. She stated her belief that a fairly significant incident must occur before the University deals with the procedural issues involved. She noted in particular the defalcation

at the San Francisco campus, which should have been detected through the audit process. She believed that the same type of thing had occurred at Los Alamos.

Mr. Schini recalled that the P-card fraud at Los Alamos had involved less than \$1 million; in performing the financial statement audit, it is not possible for the external auditors to devote the amount of time that it would take to get to that level of detail. He agreed that an increased emphasis on internal controls was warranted.

In response to further comments by Regent Hopkinson with respect to the case on the San Francisco campus, University Auditor Reed recalled that approximately \$500 million flowed through the cashiering operation annually; the defalcation was \$4.5 million. He agreed with Regent Hopkinson's point that the lack of controls in place for reconciling bank statements was inexcusable.

Regent Hopkinson believed that the administration would need to assure the Regents that there are consistent, University-wide controls in place so that everyone involved in receiving contracts and grants understands how the money should be spent. Senior Vice President Mullinix agreed that the administration should address this issue. He noted that individual funding agencies are instituting their own audits independent from those being conducted under the requirements of OMB A-133. He believed that it would be a mistake to deviate from the single-audit concept in this way. Mr. Schini agreed that this was an area of concern for the external auditors, given the decentralized nature of the University.

Regent Hopkinson pointed out that the campuses receive grants from a number of outside sources. She reiterated the request that the Regents should understand the procedures that are in place at each campus and whether or not they are adequate. If not, there should be a systemwide set of policies that must be implemented by every campus. Mr. Schini noted that, because such a request would not be within the scope of the audit, it would be discussed with management. Mr. Mullinix pointed out that decisions regarding the expenditure of funds received from contracts and grants are decentralized to the level of the Principal Investigator. University Auditor Reed commented that Vice Provost Coleman is organizing an effort to understand what level of controls the University should have over research compliance issues.

Regent Lee observed that the various departments at the University's hospitals tend to have individual computer systems and billing processes and asked how the external auditors address this. Mr. Garbrecht agreed that this is a complex area from both a business and a clinical perspective. The external auditors look at the systems that are directly relevant to the financial statements; the most difficult of these are the systems that accumulate the charges that eventually result in revenue for the hospitals.

Regent Lee raised the issue of how frequently boards of directors should meet with their external auditors without the participation of management. Mr. Schini recalled that the auditors meet with the Committee annually in a Regents Only session; he stressed that he

would have no hesitancy in raising difficult matters. Mr. Garbrecht continued that many of his clients are studying the level of communication that exists between the external auditors and the audit committee.

Following up on the comments by Regent Hopkinson, Regent Terrazas observed that it would be difficult for him to conceive of a controls system that would be foolproof in terms of fraud. In his mind, it is helpful to know whether an issue had arisen due to a fault in the design of a system or due to the level of invention of the person perpetrating the fraud. University Auditor Reed commented that what is not seen is what might have happened had management not taken the necessary steps in response to recommendations produced by internal audit. He suggested that it would be necessary to communicate more routinely with the Committee about the proactive steps that are being taken.

In response to a further comment by Regent Terrazas, Mr. Schini explained that the external auditors receive reports from the General Counsel in connection with the year-end audit and periodically throughout the year pertaining to the disclosure of litigation which is not expected to be material to the University's financial position.

2. **PROTIVITI REVIEW OF INTERNAL AUDIT PROGRAM AND REGENTS COMMITTEE ON AUDIT MATTERS**

Committee Chair Terrazas introduced Mr. Paul Sachs of Protiviti and called upon him for the presentation, which was based upon the document **Review of the Regents Committee on Audit Oversight Responsibilities and the Effectiveness of the University's Internal Audit Program**, copies of which were distributed to the Committee. Mr. Sachs explained that Protiviti had been engaged by the University to support the Committee in its review of its oversight responsibilities and the effectiveness of the University's internal audit program. The assessment will be presented as a series of five components, the first of which was an evaluation of the Committee's objectives and purpose to be assured that they are clearly and appropriately defined.

Mr. Sachs reported that the work plan undertaken by Protiviti included a review of critical documents pertaining to the Committee's work and interviews with members of the Committee and senior management in the Office of the President and at the campuses. There has been a dramatic evolution of the role of audit committees recently. With the enactment of the Sarbanes-Oxley Act, the change is expected to continue. While the spotlight has been primarily on publicly traded companies, these reforms are being embraced by all organizations. The review found that the objectives and purpose of The Regents' Committee on Audit need to be revised in order to define clearly its role in a changing environment. For example, financial expertise should be available to the Committee in order for it to meet its objectives effectively. This could be achieved through the use of an advisory committee or a consultant. Orientation and continuing education need to be considered as ways to enhance the Committee's knowledge, and the continuity of Committee leadership needs to be strengthened.

Protiviti believes that the current Bylaw for the Committee should define more clearly its role and responsibilities. Mr. Sachs noted that The Regents may wish to consider the adoption of an Audit Committee Charter or amended Bylaw for the Committee and suggested that it contain the following provisions:

- a. The Committee on Audit shall advise the Board of Regents in connection the Board's responsibilities relating to the quality and integrity of the Corporation and University's financial reporting, compliance with legal and regulatory requirements, systems of internal control and risk mitigation, independent certified public accountant's qualification and independence, and the performance of internal audit and the independent certified public accountant.
- b. The Committee shall have no fewer than five (5) members.
- c. The Committee shall meet at least four times a year.
- d. The Committee shall:
 1. 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.
 2. Review the annual internal audit plan and discuss the extent to which it addresses high-risk areas with the University Auditor and management.
 3. 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.
 4. Discuss the planned scope of the annual audit and other engagements with the independent certified public accountant and review the results of the audit and other engagements with the independent certified public accountant and management.
 5. Receive and review the annual financial statement with the independent certified public accountant and management.
 6. After considering the recommendations of management, recommend to the Board the certified public accountant to serve as independent auditor and pre-approve any services provided by the certified public accountant.
 7. Confer with the President of the University prior to the appointment, reassignment, or replacement of the University Auditor.
 8. Have the power, through its Chair, to call special meetings of the Committee and to request management to address specific issues within the mandate of the Committee, and to have the authority to engage independent counsel and other advisors to carry out its duties.

Mr. Sachs observed that audit committee member competency had been a focus of public-company reform, with audit committees gravitating towards members who are familiar with financial reporting and internal controls. Most companies are designating at least one

member, preferably the committee chair, as the audit committee financial expert. The Securities and Exchange Commission has defined this expert as a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements.
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves.
- Experience in preparing, auditing, analyzing, or evaluating financial statements or in actively supervising people engaged in such activity.
- An understanding of internal controls and procedures for financial reporting.
- An understanding of audit committee functions.

The expert must have acquired these attributes through any one of the following:

- Education and experience as a financial or accounting officer or public accountant or auditor.
- Experience actively supervising a financial or accounting officer or public accountant or auditor.
- Experience overseeing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements.
- Other relevant experience.

Given the unique governance structure of the Board of Regents, whereby membership is attained through appointment by the Governor or as a function of the political office or position held, the Board cannot always be assured that an individual on the Committee meets the qualifications of an audit committee financial expert. Protiviti recommends that consideration be given to two alternatives in order to gain access to this expertise. The first would be to form a committee of independent advisors who meet the audit committee financial expert criteria. These advisors would attend the Committee's meetings and act to advise the Committee as it discharges its responsibilities. A second alternative would be to hire an independent consultant who meets the audit committee financial expert criteria. The consultant would attend the Committee meetings and act to advise the Committee as it discharges its responsibilities. The consultant could also be responsible for providing the Committee members with orientation and continuing education.

The second component of the Protiviti review was an evaluation of the delegation of authorities, the communication channels, and the reporting relationships to determine that they provide an opportunity for the appropriate level of oversight by The Regents and foster the independent, unbiased, levels of communication necessary to assure the policies of the University are upheld. Mr. Sachs reported the following conclusions:

- As the importance of the duties of audit committees increases, so does the level of oversight of accounting and financial reporting as well as various other regulatory

and audit matters. The suggested charter will cause the Committee on Audit to increase its oversight.

- Management, the external auditor, and the University Auditor have historically presented information in line with the suggested charter, but the time devoted to the information has not always allowed the Committee to be well informed about financial operations and reporting, internal control systems, compliance, and related matters. Changes have been implemented over the past year to provide time for the Committee to ask the questions necessary for adequate oversight.
- The Chair of the Committee is pivotal to proper oversight. Best practices have the Chair engaged in discussions with management, the external auditor, and the University Auditor as issues evolve and setting the meeting agenda to devote adequate time for education and dialogue on key issues. At the University, this involvement has varied with the Chair. An active level of involvement will foster a greater level of independent and unbiased communication.
- The historical meeting structure may tend to inhibit independent and unbiased levels of communication. This is a sensitive issue with a governmental entity subject to open meeting laws. Best practice recommendations include executive sessions by the Committee separately with the external auditor, University Auditor, and management. Typically these executive sessions cover potential independence issues such as difficulties that the external auditor or University Auditor encountered in the course of their work, including restrictions on their scope or access to information or significant disagreements with management. The Committee has held executive sessions in the past with the external auditor. Similar executive sessions should be held with the University Auditor and with management.
- The Committee historically has not dealt with the results of the other audits performed by the external auditor. These include the A-133 audit of the federal financial assistance programs, the NCAA audit, bond program audits, and hospital audits. The Committee should routinely hear the scope and results of these engagements as a part of its oversight.

The third part of the work performed by Protiviti consisted of a review of the procedures, processes, and organizational structure that assure the independence of all the various elements that comprise the internal audit function. As a result of the review, Protiviti finds that the dual reporting organizational structure in place provides for a greater involvement of internal audit and generally provides for independence on the part of the internal audit professionals. Mr. Sachs recalled for the Committee that the defined services of internal audit comprise the following:

Audit:	Planned and supplemental program of regular audits of business units and business processes that cut across organizational units.	65%
Investigations:	Investigations into suspected financial irregularities, whether reported by whistleblowers, uncovered in the course of regular audits, or based upon concerns conveyed by management.	15%
Advisory Services:	A broad array of activities beyond regular audits, including <ul style="list-style-type: none"> - Internal control and accountability - Special projects and consultation - Systems development and reengineering. 	20%

The Internal Audit Manual clearly describes the responsibilities of the internal auditors for reporting the results of their work while maintaining their independence. The new whistleblower policy has created a stronger independent structure to deal with investigations, which are carried out at the local level by the designated officer.

Protiviti is recommending that, in order to enhance independence, the University Auditor should assume full responsibility for some duties that are currently shared with management at the campuses and the laboratories. They consist of the following:

- Approval of the audit plan
- Annual performance evaluation of the Internal Audit Director
- Determination of the compensation of the Internal Audit Director
- An assessment the adequacy of the resources
- Approval of changes to the audit plan

Mr. Sachs continued that a standard local audit committee charter should be considered in order to provide greater consistency among the committees at the campuses and the laboratories. Local audit committee meetings are not always held at least 3 times per year, as provided for in the Manual, and attendance by management can vary based on the perception of the importance of the committee. This should be monitored by the University Auditor and communicated to the chancellors and the laboratory directors.

The Manual provides conflicting descriptions of the advisory services that internal audit may provide to management. This can cause the auditor to perform services that could impair his or her independence. A clearer definition of the services that are allowable needs to be communicated. The University Auditor also needs to monitor the types of projects performed in order to assure that they are appropriate as advisory services where the reporting is less formalized.

Certain sensitive investigations should be performed by the University Auditor or an outside consultant if the independence of the campus or laboratory auditor could be impaired. The investigative services provided at the campus and laboratory are monitored by the University Auditor on an ad hoc basis. This does not provide adequate oversight in monitoring the timely completion of the investigations or provide the ability to monitor trends that may be indicative of independence issues. Development of a case management tool would allow the University Auditor to better monitor this area.

As a best practice, the University Auditor should meet annually with the chancellors and the laboratory directors to review the conduct of the audit plan. This sets the tone for the importance of the work being performed by internal audit and also opens up communication with the top of the organization.

The Manual does not formally require that the University Auditor receive annually a signed statement of compliance with professional standards from all auditors. While some campuses are doing this, the practice should be incorporated into the policy.

The fourth component of the Protiviti review included a review of the practices, policies, and procedures for reporting audit findings and conclusions in comparison to professional standards and best practices, with a view towards assuring independence and objectivity. The report reached the following conclusions:

- Internal Audit maintains a formal process for communicating to management and The Regents the results and recommendations for all audits conducted.
- Audit report drafts are reviewed with the operating management responsible for the audited activity. This is done to confirm the factual accuracy of the findings and is a practice endorsed by professional standards.
- The Manual provides policies to the professionals for resolving disputes with auditees. It clearly states that the professional judgment of the internal auditors cannot be overridden or unduly influenced by audit clients. It further states that the judgment of the Internal Audit Director is final and cannot be appealed to the University Auditor or senior management.
- The Manual needs to describe more clearly the procedures to be used in reviewing drafts of investigative reports. It states that procedures similar to those used for the review of audit reports should be employed. Given the potential sensitivity of the subject matter of the investigation and the results, a more guarded approach should be considered.

The final component of the engagement was a review of the Committee's responsibilities in light of the Sarbanes-Oxley Act of 2002. The Committee members concurred with the

suggestion made by Regent Hopkinson that, due to the detailed nature of the comments, discussion of this section of the report should be deferred to the May meeting.

Senior Vice President Mullinix stated for the record that the findings reported by Mr. Sachs had not been discussed with University Auditor Reed or Vice President Broome prior to the meeting.

Regent Lee stressed that, as a public institution, the University should be held to even higher standards than are corporations. He believed that The Regents should adopt the provisions of Sarbanes-Oxley even though the law does not cover institutions of higher education. With respect to the best practices for the Committee as outlined by Mr. Sachs, Regent Lee felt that The Regents would be better served by an outside consultant than by an advisory committee. He also believed that the University should have a chief financial officer with independent reporting responsibilities similar to those of the University Auditor

Regent Hopkinson stated that Mr. Sachs' report had not given her an understanding of the internal audit process, and she raised a series of issues and requests that she would like to see addressed at the Committee's May meeting:

- She requested an organizational and a functional diagram of the internal audit process, as well as an outline of the whistleblower policy.
- She wished to have a better understanding of the responsibilities of the internal auditors with respect to compliance with policies such as Proposition 209 and those dealing with sexual harassment. The University should have a process for reviewing those policies that are not within the purview of internal audit.
- There should be a discussion of the Committee's governance structure, including the frequency of its meetings. She urged that consideration be given to scheduling the Committee's meetings in conjunction with those of The Regents in order to improve attendance.
- She concurred with Regent Lee's assessment that an external consultant to the Committee would be preferable to an advisory committee.
- She did not believe that the Committee received adequate reports from management on issues such as whistle blowers and internal audit investigations. She acknowledged the challenge which arises with respect to privacy issues. She suggested that, in addition to receiving reports from the University Auditor, the Committee should meet at least annually with the internal audit directors from the campuses and the laboratories. She believed that issues should always be reported to the Office of the President when senior campus officials are involved.

Committee Chair Terrazas stated his appreciation of the acknowledgment by Protiviti that there is a need for the Committee to understand the scope and jurisdiction of its charter and to be provided with orientation and continuing education. He supported the views of the governance structure outlined by Regent Hopkinson, noting in particular that the kind of session the Committee requires cannot be compressed into a short period of time. Regent Terrazas also agreed with the recommendations in the report pertaining to the transfer of certain oversight responsibilities to the sole jurisdiction of the University Auditor.

In response to a further comment by Regent Terrazas, General Counsel Holst explained that there is a clear and established method by which amendments are made to the Bylaws and Standing Orders of The Regents. In this case, the recommended amendment could be formulated by the Committee if it so wished.

Mr. Sachs was hopeful that the strategies he had outlined would provide the right structure and focus for the organization. He stated his intention to work with management on some of the issues that had been raised by Regent Hopkinson.

University Auditor Reed suggested that it would be helpful for him to provide a written response to the set of recommendations contained in the Protiviti report. This would be in addition to the issues to be addressed by Mr. Sachs at the May meeting.

Regent Lee agreed with the views expressed by Regent Hopkinson with respect to the scheduling of the Committee's meetings. Mr. Mullinix observed that the scheduling of "off-cycle" meetings had been experimental, but he stressed that the quality of the Committee's discussions had improved dramatically under the new schedule. He stated a commitment to holding meetings of the Regents over several days, with sufficient time being devoted to each Committee.

In response to a comment by Regent Hopkinson regarding the need for strong support for the internal auditors, Committee Chair Terrazas reported that he had attended the All Auditors Conference in Napa in February; he was convinced that they receive a high level of support from management. Regent Hopkinson stressed that there must be a commitment at all levels to do the right thing, regardless of who is involved. University Auditor Reed commented that the internal auditors are aware that their responsibilities reach all the way to the Committee.

3. **UPDATE ON LOS ALAMOS NATIONAL LABORATORY**

University Auditor Reed reported on the efforts that are under way to strengthen the internal audit program at Los Alamos, noting that he now serves as the interim internal audit director for the laboratory. The internal audit departments of the three national laboratories now report directly to the University Auditor. The so-called "loyalty oath" has been rescinded; this oath had edited the professional standards to which staff were being asked to adhere to such an extent that it had inhibited their independence. Senior staff from the Office of the

President have been conducting reviews of several of the audit and assessment functions. A Pinkerton Hotline which reports to the Office of the President has been established for employees who wish to serve as whistle blowers. This allows for freer communication between management and the employee through the use of a third party. The Office of the University Auditor has undertaken the investigation of missing property from the security division. University Auditor Reed recalled that when he became involved with the situation at Los Alamos in December 2002, there were 33 open investigations; that number has grown to 153, with 66 being property issues. The auditors have also begun to clean up a backlog of 290 open audit findings that had not been validated as to management's corrective action. In addition, PricewaterhouseCoopers has been engaged to assist in assessment, prioritization, and catch-up efforts for both investigations and open audit findings. The plan is to be current on both backlogs by the end of April. Finally, contacts and communications protocols are being established with the Department of Energy in Washington, Albuquerque, and Los Alamos.

Vice President Broome recalled that, as noted above, PricewaterhouseCooper's original investigation of the P-card program has been expanded to the laboratory's entire procurement system. PwC has been asked to review the procedures that will be used in a "wall-to-wall" inventory at the laboratory and to validate the fact that those procedures were used. In addition, the University has retained Ernst & Young to review all key business processes, with the exception of procurement. Both firms expect to issue their reports by the end of March. A "red team" consisting of property, procurement, and technology specialists from Lawrence Livermore National Laboratory conducted a review of the organizational structure, business procedures, and financial systems of the procurement and property functions, and a transitional organizational structure consisting of personnel from Livermore has been put into place. An attempt is also being made to institute consistent procedures for all three national laboratories; a uniform P-card procedure has already been adopted.

In response to a question from Regent Lee, Vice President Broome noted that a complete wall-to-wall inventory is not conducted every year, nor is it required by the Department of Energy. Both Livermore and Los Alamos perform these inventories every five years.

Senior Vice President Mullinix commented that, while the amount of money involved at Los Alamos was not large, in an environment where there are nuclear weapons it is difficult to defend the failure of the processes.

4. INTERNAL AUDIT MATTERS

A. *Mid-Year Review of Audit Plan Status*

University Auditor Reed noted that, for the quarterly report ended December 31, 2002, the numbers had been modified in order to reflect the inclusion of all audit functions for Los Alamos and Lawrence Livermore National Laboratories within internal audit retroactive to October 2002, thereby adding 22 people to the audit

function. These additional staff members are involved in contract auditing, external audit coordination, and investigations, and historically were not included because reporting to the Department of Energy was only for the direct internal audit program.

Mr. Reed presented some highlights for the quarter, noting first that staffing levels have not yet been affected by budget constraints. The mix of efforts is in line with the prior year and the audit plan, although investigation hours at the campuses are up 50 percent over the prior year and 12 percent compared to the plan. This may be the result of the new whistleblower policy, which established new mechanisms for allegations to be reported. The Pinkerton Hotline has been expanded, and there will be a single phone number for the University as a whole. Mr. Reed continued that a full-day training program for all campus and laboratory coordinators of the whistleblowing policy had been held in November, and “train-the-trainers” programs were put on in the north and the south to communicate a greater awareness of the policy. Due to provisions in State law, a “protected disclosure” may be made to anyone with line supervisory responsibility and may be verbal in form. The presence of both Regent Terrazas and Senior Vice President Mullinix at the All Auditors Conference sent a message to the internal auditors about the importance of their work.

B. *2004 Audit Planning*

University Auditor Reed reported that the audit plan for fiscal year 2004 will be presented at the Committee’s May meeting. A risk assessment process is under way. The campus and laboratory audit committees meet to discuss risk. Mr. Mullinix observed that these meetings are taken seriously, with some chancellors chairing the committees. Federal auditor workplans are also taken into consideration. There is an assessment of each auditable area of activity, approximately 3,000 systemwide, to determine risk factors. University Auditor Reed outlined the following risk factors for the audit plan:

- The quality and stability of the control environment
- Business exposure (materiality and liquidity)
- Public and political sensitivity
- Compliance requirements
- Information technology and management reporting

Some high-level risks include growth and its impacts, budget constraints, new regulations, procurement activities, new systems development projects, and research compliance.

C. *Status of Significant Investigations*

Mr. Reed reported that there are no cases that need special attention. He brought to the Committee's attention the fact that the 1999 cashiering case at the San Francisco campus had been resolved, with the former cashier being sentenced to six years in prison, but with the expectation that she would serve only three.

D. *External Audit Agency Activity*

University Auditor Reed commented briefly on some of the audits that are under way, including those by the Bureau of State Audits and the General Accounting Office.

Regent Lee suggested that at each meeting the Committee be provided with a detailed report on matters such as the NCAA audit. Senior Vice President Mullinix noted that the administration had been discussing the best way to summarize this type of information in order to provide a sense of the nature of the issues. University Auditor Reed continued that best ways in which to communicate with the Committee were under discussion with the internal auditors.

The meeting adjourned at 1:35 p.m.

Attest:

Associate Secretary