

The Regents of the University of California

**COMMITTEE ON AUDIT**

May 14, 2003

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

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

In attendance: Faculty Representative Pitts, Secretary Trivette, General Counsel Holst, Treasurer Russ, Senior Vice Presidents Darling and Mullinix, Vice President Broome, University Auditor Reed, and Recording Secretary Bryan

The meeting convened at 4:35 p.m. with Committee Chair Terrazas presiding.

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

Upon motion duly made and seconded, the minutes of the meetings of November 13, 2002 and March 13, 2003 were approved.

**2. APPROVAL OF ADDITIONAL AUDIT PROCEDURES FOR THE DEPARTMENT OF ENERGY LABORATORIES FOR THE YEAR ENDING JUNE 30, 2003**

The President recommended that the audit procedures for the Department of Energy Laboratories described in the *External Audit Plan for the Year Ending June 30, 2003*, approved by interim authority on March 20, 2003, be amended by the addition of the following:

- Expanded review of balance sheet accounts at all laboratories.
- Review of corrective actions taken for the Los Alamos National Laboratory in the areas of procurement card; procurement; organizational study of the financial structure, including controls review; and property management structure.
- Review of results of Inspector General or internal audits at Livermore and Berkeley in areas of property management, sensitive property, procurement-card transactions, and corrective actions.

Vice President Broome recalled that at the Committee's March 13 meeting, the annual external audit plan was presented by The Regents' external auditors, PricewaterhouseCoopers (PwC). At that meeting, the indication was that scope changes would likely be necessary after an evaluation of the procedures to be performed was completed. Ms. Broome then called upon Mr. Mike Schini, the engagement partner, and Mr. Rick Wentzel, the senior manager for the audit, for their comments. Mr. Schini recalled that, due to discoveries of inappropriate transactions at the Los Alamos National Laboratory, University management and external agencies had undertaken studies of the organizational

structure and controls related to the laboratories. These agencies include the Office of Inspector General, the General Accounting Office, Ernst & Young, and PwC. Because many of these studies and audits are recently issued or still in process, corrective actions are not yet complete. Mr. Schini explained that PwC is first recommending that the external audit include an expanded review of balance sheet accounts at all of the laboratories, as these balance sheets are not consolidated in the University's financial statement. Special studies at Lawrence Berkeley National Laboratory and Lawrence Livermore National Laboratory are under way in the areas of property management, sensitive property, purchase card, and controls review over major cycles (only at Livermore). In addition, KPMG and the General Accounting Office will visit all of the laboratories to perform reviews of selected control cycles. PwC proposes to undertake a review of the corrective actions taken at Los Alamos in the areas of procurement card, procurement, organizational study of the financial structure including controls review, and property management structure, and to review the results of Inspector General or internal audits at Berkeley and Livermore in the areas of property management, sensitive property, procurement-card transactions, and corrective actions.

Committee Chair Terrazas recalled that at the Committee's March 13 meeting there had been a brief discussion of the implementation of GASB No. 39, "Determining Whether Certain Organizations Are Component Units." Mr. Schini confirmed that, when adopted, this standard will require the inclusion of financial information about the University's independent foundations in its financial statements as a discretely presented component unit. He stated that PwC would be working 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.

Regent Hopkinson suggested that attention should be focused on the Berkeley and Livermore laboratories to ensure that anything that should be brought to light has been. Mr. Schini explained that the studies being undertaken by the Inspector General are intended to cover areas that are in common with Los Alamos. PwC intends to review the results of these audits. Senior Vice President Mullinix stressed that while there is room for improvement at all of the laboratories, he did not anticipate that the Inspector General would uncover problems as serious as those at Los Alamos.

In response to further comments by Regent Hopkinson, Vice President Broome underscored the importance of PwC's expanded review of the balance sheet accounts, which are not included in the University's financial statements; PwC will be asked to perform this work at the laboratories on an ongoing basis. Mr. Schini observed that the work to be performed by PwC will be partially duplicated by the work being done by the auditors for the Department of Energy; the University and the federal government, however, have different fiscal years, resulting in a somewhat unusual situation.

Regent Hopkinson raised the issue of personnel matters at the laboratories. University Auditor Reed commented on the various processes which bring such issues to the attention of management, including grievance and dispute-resolution processes. Internal Audit

performs limited audit work in the areas of employment practices and personnel policies. He did not believe that personnel recruitment practices and dispute-resolution processes had been regularly subjected to internal auditing. Regent Hopkinson suggested that, based upon the culture at Los Alamos and Lawrence Livermore, there was the potential for significant challenges in that area. She stressed that Internal Audit should be able to uncover problems before an employee must resort to being a whistle blower.

Regent Lozano suggested that it would be helpful when changes are proposed to the scope of an audit if the Committee were informed of what other auditors are working on in the context of the work to be performed by PwC. She felt that the bifurcated approach to auditing at the laboratories could lead to potential problems and believed that some agreement should be reached with the DOE about areas of responsibility. Mr. Schini continued that materiality issues can arise at the laboratories because they are not visited fully by their external auditors on an annual basis. This fact does not affect The Regents' financial reporting but does raise stewardship issues. Regent Lozano agreed with the comments made by Regent Hopkinson with respect to the importance of employment practices and personnel issues and asked that they be reviewed by Internal Audit regularly.

Faculty Representative Pitts commented on the disparities between the laboratories and the campuses with respect to the issues raised by Regent Hopkinson, noting that the campuses produce numerous diversity- and gender-related reports on a regular basis. Consideration might be giving to treating these issues in a similar fashion at the DOE laboratories.

In response to a question from Dr. Pitts regarding the audit working performed at the laboratories to date, University Auditor Reed believed that the work had been very comprehensive in the areas of procurement, property, and business activities. DOE's historical assessment of the laboratories has not been based solely on audits but on self-assessments and performance measures that were built into the contracts beginning in 1992. The University is beginning to realize that false readings may be obtained if the right performance measures are not in place. 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.

Vice President Broome commented that while she had been disappointed in the number of control weaknesses that had been uncovered during the audits, she was impressed with the rapid way in which the problems were being addressed. There has been a strict assignment of accountability and responsibility at the laboratories.

In response to a question from Committee Chair Terrazas with respect to the detection of fraud, Mr. Schini observed that it is difficult to find specific instances of fraud using a sampling method, even forensic sampling. Most such instances are reported by a whistle blower. University Auditor Reed continued that fraud tends to occur in a limited number of transactions, even if the illegal activity is ongoing. Studies by the American Institute of Certified Public Accountants and by the Certified Fraud Examiners have shown that regular

audit work is able to detect only five percent of the fraud that is investigated in a company. This holds true for the University of California.

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

### 3. ANNUAL REPORT ON INTERNAL AUDIT PLAN, 2003-04

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Plan, 2003-04**, 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 observed that the overall objective of the internal audit plan is to deploy resources effectively and efficiently in order to meet multiple objectives, which include the following:

- Providing an audit program that addresses contemporary risks while ensuring appropriate attention to core business functions and broad audit coverage of the University over time.
- Assuring adequate audit attention is directed to unique campus, health science, national laboratory, and Office of the President activities.
- Having available sufficient resources to perform investigations as necessary without excessive intrusion on the audit program and being available for consultations, special projects, and other management assistance as appropriate.

The intention of the plan is to devote 47 percent of internal audit efforts to areas of perceived highest relative risk and 46 percent to core business activities. Because of the overlap between the two areas of activity, when combined they will consume 70 percent of the effort, leaving 30 percent of the audit hours available for a program of broad audit coverage and supplemental and other services. The plan will commit resources among the University's operating lines of business as follows: campuses 47 percent, health sciences 21 percent, national laboratories 27 percent, and the Office of the President 5 percent. These statistics reflect a substantial increase for the national laboratories as compared to the prior year due to the inclusion of all audit-related functions in their reporting to the University Auditor and The Regents. Mr. Reed continued that the plan will allocate 58 percent of available effort to a program of planned and specially requested audits, 19 percent to advisory services, 16 percent to investigations, and 7 percent to audit support activities. As compared to both the plan for the current year and the actual experience through March 31, 2003, next year's plan assumes that an increase in investigation effort will be required at the expense of advisory services. The percentage of time planned to be devoted to the program of regular

and special audits is the same as the prior year plan and, at 58 percent, demonstrates that this is clearly the first priority.

Committee Chair Terrazas recalled that at the Committee's March meeting, University Auditor Reed had discussed the implementation of the University's whistleblower policy and the expansion of the Pinkerton Hotline and asked how these functions fit into the overall internal audit plan. Mr. Reed explained that the investigations program is separate from both the core audit and advisory services. Investigations are opened as allegations are received, with charges involving senior management being reported to Senior Vice President Mullinix. Internal Audit staff across the system will be assisting with the implementation of the new policy. Mr. Reed recalled that one of the first steps undertaken at Los Alamos had been the establishment of a hotline for whistle blowers, with 13 calls being received, the majority immediately following implementation.

Returning to his presentation on the internal audit plan, University Auditor Reed referred to a graph which displayed the historical mix of audit, advisory services, and investigation hours. This graph clearly demonstrates that auditing is the core service being performed. He drew the Committee's attention to the areas of high-risk coverage for the campuses/Office of the President, the health sciences, and the DOE laboratories.

Regent Hopkinson recalled that at the Committee's March meeting she had expressed her serious concerns about certain functions at the University that are not audited or overseen on a regular basis. University Auditor Reed noted that her concerns had centered on issues such as compliance with Proposition 209, sexual harassment policies, and employment practices. Regent Hopkinson stressed that the failure to address these issues could be costly to the University, given the litigious nature of society. The University must have established policies in order to protect itself and in order to prevent unanticipated problems from occurring. With respect to whistleblower allegations, Regent Hopkinson asked that any charge which involves a senior executive be reported to management in writing and also be communicated to the Committee in a clear, articulate fashion.

University Auditor Reed commented that Internal Audit seeks and welcomes input on the internal audit plan about areas of risk that should be addressed. He noted that recruitment processes are included when an audit of human resources is performed.

With respect to policies that pertain to sexual harassment, Regent Hopkinson believed that an audit would be required to ensure that the correct procedures are in place and are being implemented.

Mr. Reed agreed with the comments expressed by Regent Hopkinson, noting that the whistleblower policy establishes that any allegation against a vice chancellor to whom the auditor reports would constitute a conflict of interest for that internal auditor. Such an investigation would be conducted by the Office of the President.

Regent Hopkinson asked that University Auditor Reed and Senior Vice President Mullinix formulate a recommendation with respect to whistleblower allegations that involve senior executives and present it to the Committee for adoption.

Mr. Mullinix commented that research has the potential for compliance problems. He noted that a program was being implemented on the academic side for this area of concern and stated the intention to provide a report on the implementation of this program to the Committee.

Committee Chair Terrazas commented on the fact that the Committee's responsibilities encompass more than the financial statements of the University. The Regents need to be informed of any areas that are not being fully addressed, either by Internal Audit or by other responsible departments. Senior Vice President Mullinix recalled that a compendium of compliance activities at the University had been compiled by General Counsel Holst and University Auditor Reed. He suggested that it might be worthwhile to review the list with an eye toward how well these activities are being performed. Each of the areas of compliance will be addressed sequentially and then reported to the Committee. Regent Hopkinson suggested that the report on compliance include a chart listing each area of activity and what improvements need to be made.

University Auditor Reed added that he had identified 20 locations within the University where allegations are investigated, depending on the nature of the allegation. The purpose of the whistleblower policy is to ensure that allegations are funneled in such a way that the institution addresses them correctly. Regent Hopkinson stressed that she was concerned about issues that may go unnoticed but still could cause problems for the University.

#### 4. **PROTIVITI REVIEW FOLLOW-UP**

Committee Chair Terrazas invited Mr. Paul Sachs of Protiviti to present his comments. Mr. Sachs recalled that at the March meeting, the Committee had requested time to review the information he had provided concerning the Sarbanes-Oxley Act of 2002. The intention was to assist the University, which is not subject to the legislation, to understand what the implications might be for the organization. Mr. Sachs summarized his findings that a third of the requirements of the law are already in place at the University, a third are reforms that would make good business sense for the University, and a final third of the corporate reforms may not be appropriate for an organization like The Regents. He cited as an example concerns about the structure of the governing board and in particular the Audit Committee; because the Regents are either appointed by the Governor or serve in an ex officio capacity, problems which occur in the private sector do not arise. Under Sarbanes-Oxley, the membership of the Committee could not include constitutional members of the Board because of independence issues. Another area of sensitivity that the Board should consider seriously before adopting concerns the requirement that the CEO and CFO of a corporation certify financial reports on a quarterly basis. Protiviti is not aware of any college or university that requires these certifications. Another feature of the legislation is the

requirement that the external auditor render an opinion on the internal controls, a large undertaking which is now faced by private corporations. The University's accounting system follows budgetary accounting policies rather than generally accepted accounting principles, and there is a conversion at year end for the financial reporting. Mr. Sachs believed that asking the external auditor to comment on the internal controls would be a very time-consuming process which should be carefully understood before consideration is given to adopting this policy. He observed that the legislation is beginning to gain some attention among tax-exempt organizations, primarily hospitals that issue tax-exempt revenue bonds, with rating agencies asking what provisions similar to those of Sarbanes-Oxley are in place. The University could come under pressure to implement certain, if not all of the provisions of Sarbanes-Oxley. To do so may require structural changes within the organization as well as statutory amendments in order to be in true compliance with the law.

Regent Lozano observed that one way in which the legislation could be applied to the Board would be to require appointed Regents to disclose significant financial transactions with the University, which could preclude service on the Committee. She suggested that the University could adopt a certification process for the financial statements that would provide the Regents with a greater understanding of the internal controls.

Senior Vice President Mullinix asked that University Auditor Reed prepare a response to the recommendations made by Protiviti with respect to the implementation of certain provisions of Sarbanes-Oxley for consideration by the Committee at its July meeting. Committee Chair Terrazas observed that one of the issues raised by Regent Lozano was the composition of the Committee, noting that Protiviti had recommended that an outside consultant might be required to guide the Committee as it performs its expanded scope of work.

Regent Hopkinson believed that consideration should be given to adoption of all of the provisions of the law; it was agreed that the response prepared by the University Auditor would have comments on each of its provisions. Regent Terrazas stressed that the Committee would need to begin its response to the recommendations made by Protiviti at the March meeting by considering the adoption of a charter.

In response to a question from Regent Hopkinson, General Counsel Holst confirmed that there is a coordinator in his office who reviews transactional matters that come to the Board for approval; over the years, a few Regents have been disqualified from the decision-making process as a result of financial interests.

Senior Vice President Mullinix stated his intention to provide a response to the Protiviti report as well as to propose a charter for the Committee.

Regent Connerly raised the issue of attendance by members of the Committee and urged Chairman Moores to assist with achieving a quorum in the year to come.

## 5. **UPDATE ON LOS ALAMOS NATIONAL LABORATORY**

University Auditor Reed reported that, since the Committee's March meeting, the Inspector General had issued an audit which questioned the costs of the internal audit program for the entire three years of the review. The IG in particular was not satisfied by the work performed with respect to vendor audits. Issues of independence were raised which have since been addressed. The University has put in place a catch-up plan for all outstanding audits, to be accomplished by September 30 using specialized outside contractors. The Inspector General criticized Internal Audit for its failure to have an effective follow-up process, which was one of the first deficiencies uncovered by the University. In particular, no follow up had been taken on 271 audit findings to ensure that management had taken corrective action. Mr. Reed reported that by April 30 all 271 cases had been reviewed, with the finding that in 91 percent of the cases corrective action had been put into place. The outstanding cases are the subject of new management action plans.

**6. INTERNAL AUDIT MATTERS**

University Auditor Reed noted that, in response to a request made by Regent Hopkinson at the March meeting, he had distributed to the Committee flow charts displaying the internal audit process and the general audit process for the University.

The meeting adjourned at 5:45 p.m.

Attest:

Secretary