

University of California

Audit and Communications Plan for Year Ending June 30, 2004



February 5, 2004

To the Regents' Committee on Audit:

Dear Committee members,

We are pleased to present to you our audit and communications plan, which includes a summary of our mutual understanding and expectations between you and others within your organization and PricewaterhouseCoopers LLP's roles and responsibilities, our audit approach, audit and reporting timetable and other matters. Discussion of our plan with you ensures our engagement team members understand your concerns and that we agree on mutual needs and expectations to provide the highest level of service quality. Our approach is responsive to the many changes affecting University of California.

If you have any questions regarding this plan, please contact Michael Schini at 408-817-4478 or Elaine Garvey at 415-498-8068.

Yours very truly,

PricewaterhouseCoopers LLP



Table of Contents



	Page(s)
Communications Plan	3
PwC Principles and Practices	4
Terms of Engagement	5
Independence Confirmation	6
Corporate Governance: Roles and Practices	7
Audit Plan	8-16
New Accounting Standards	17
Audit Plan: Risk Analysis	18-27
Perspectives on Fraud Risk	28
Appendices	

Note: this document is intended solely for the use of the Committee on Audit and the management of the University of California.



Communications Plan

	Getting started March 2004	Understanding the audit March 2004	Staying informed March – September 2004	Resolution and completion November 2004
Service approach	<ul style="list-style-type: none"> PwC Principles and Practices (see appendix 1) Terms of Engagement Independence Confirmation Communications Plan Elements (see appendix 2) 	<ul style="list-style-type: none"> Audit plan <ul style="list-style-type: none"> Roles and Responsibilities Audit Objectives & Scope Audit Approach Audit and Reporting Timetable Engagement Team 		
Risk and control		<ul style="list-style-type: none"> Audit Plan: Risk Analysis Perspectives on Fraud Risk 	<ul style="list-style-type: none"> Perspectives on fraud risk Confirm/update risk assessment Update on accounting/audit issues and risk analysis 	
Financial reporting			<ul style="list-style-type: none"> Update on accounting/audit issues and risk analysis Early assessment of Annual Report 	<ul style="list-style-type: none"> Opinion on financial statements Required communications, including <ul style="list-style-type: none"> Internal control deficiencies Accounting policies Management judgments Reaffirm independence Discussion of Transparency
Governance	<ul style="list-style-type: none"> Corporate governance: roles and practices (refer to separate publication for audit committees provided to you) 			<ul style="list-style-type: none"> Assessing our performance and yours

Ongoing assessment of needs & expectations



PwC Principles and Practices

- In today's challenging business and corporate reporting environment, we believe it is important that you remain confident about:
 - (i) the quality of our audit work
 - (ii) our steadfast commitment to independence and quality
- We recognize the importance of a strong and effective relationship between the Committee on Audit and independent auditors.
- The PwC Principles & Practices Regarding Our Relationships With Client Audit Committees highlights our values and principles. We include this monograph as Appendix 1.



Terms of Engagement

- Our **engagement letter** sets out the terms of our appointment as auditors of University of California (“UC” or the “University”).
- The engagement letter covers the following matters:
 - Scope of annual audit for the year ending June 30, 2004.
 - Our responsibilities and limitations.
 - Management’s responsibilities.
 - Other documents.
- A copy of our **engagement letter** has been provided to you under separate cover.



Independence Confirmation

- We confirm our independence of UC as of February 5, 2004.
- We have not been requested to perform any consulting services since the Regents' new policy. Audit related services were performed for the period ended June 30, 2003 primarily related to investigations and forensic audits at Los Alamos and Berkeley Laboratories. The fees related to these services will be separately reported to you by management.
- Our quality control processes are established to ensure our continuing independence.
- We will again reconfirm our independence at the completion of our June 30, 2004 audit.



Corporate Governance: Roles and Practices

- Our role and practices as independent auditor:
 - To be familiar with the charter of your Committee on Audit.
 - Provide our viewpoint on the design effectiveness of the Charter and governance objectives based on our assessment.



Audit Plan: Roles and Responsibilities

Regents' Committee on Audit

- Oversee the reliability of financial reporting including effectiveness of internal control over financial reporting.
- Review and discuss the annual financial statements and determine whether they are complete and consistent with operational and other information known to Committee members.
- Understand significant risks and exposures and management's response to minimize the risks.
- Understand the audit scope and approve audit and non-audit services.



Audit Plan: Roles and Responsibilities

Management

- Properly record transactions in the accounting records, establish and maintain internal control sufficient to permit the preparation of financial statements and information in conformity with GAAP.
- Prepare the financial statements.
- Make available to us, on a timely basis, all of UC's original accounting records and related information and UC personnel to whom we may direct inquiries.
- Adjust the financial statements to correct material misstatements and intentional misstatements; and affirm to us, that the effects of any uncorrected misstatements are immaterial, both quantitatively and qualitatively to the financial statements taken as a whole.
- Provide written representations to us regarding the financial statements and the effectiveness of internal control over financial reporting.
- Ensure UC complies with the laws and regulations applicable to its activities, especially those related to federal and state contracts and awards.



Audit Plan: Roles and Responsibilities

PricewaterhouseCoopers

- Confirm expectations with the Committee on Audit and management. Monitor and report actual performance against those expectations.
- Conduct our audit in accordance with auditing standards generally accepted in the United States and Government Auditing Standards.
- Meet with the Committee on Audit to communicate matters required by professional standards and other matters of interest.
- Support the Committee on Audit's fiduciary responsibility to ensure the effectiveness of internal controls. Provide observations regarding key business processes and recommendations for improving internal controls.
- Discuss issues and concerns with management as they arise. Report significant matters as soon as they are confirmed.



Audit Plan: Roles and Responsibilities

PricewaterhouseCoopers (continued...)

- Provide management with proactive accounting and regulatory technical advice and provide timely access to PwC accounting and reporting experts to address unusual and non-routine items.
- Provide an accessible, experienced team with appropriate industry and technical expertise and align the team with the UC management structure to ensure the effective resolution of issues.



Audit Plan: Audit Objectives & Scope

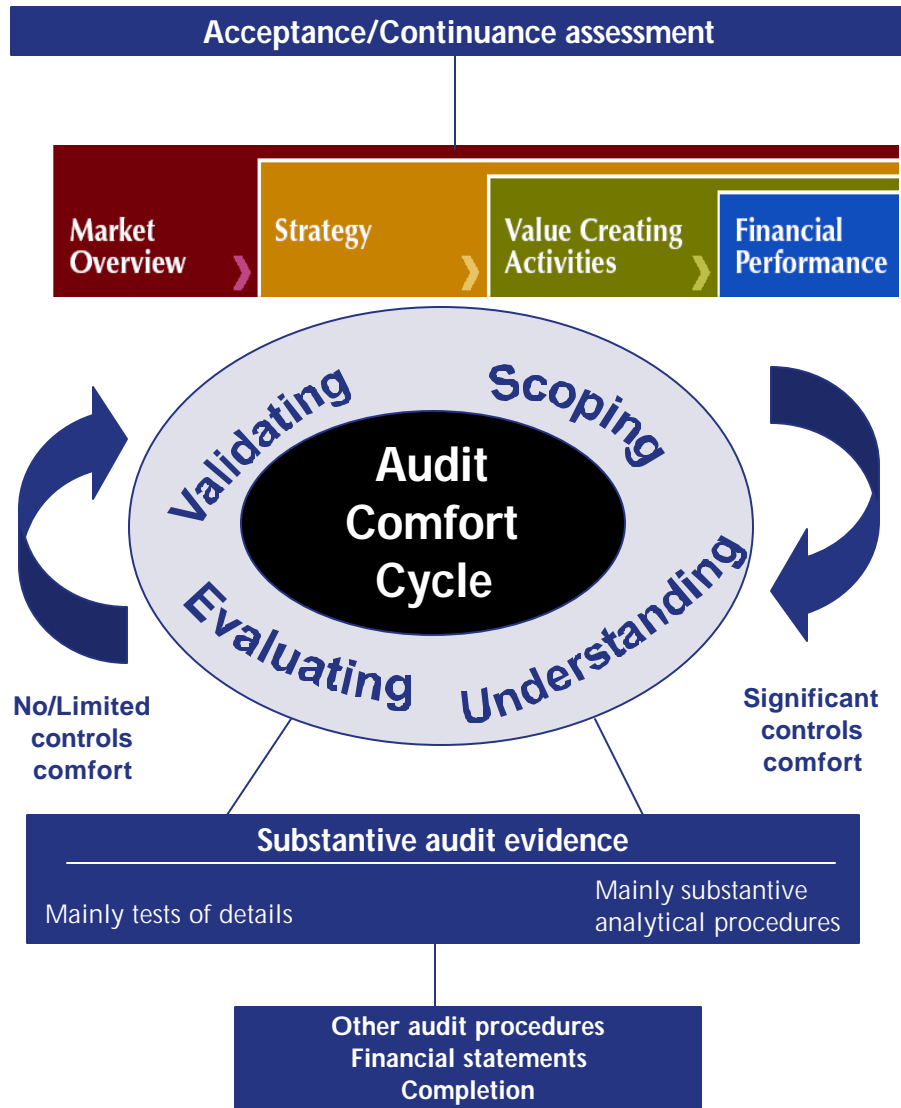
- Issue our audit reports to the Board of Regents of UC, respectively, unqualified as to scope, on UC's financial statements for the year ending June 30, 2004. We will also perform audit procedures to be compliant with Government Auditing Standards for UC.
- Read the other information included in UC's annual reports and other documents, and consider whether such information, including the manner of its presentation, is materially consistent with the information appearing in the financial statements.
- Provide assistance to the Committee on Audit in discharging its corporate governance and compliance responsibilities.
- Perform an audit to test compliance with certain laws and regulations relating to Federal awards programs under OMB Circular A-133.
- Communicate recommendations for the improvement of controls and processes.
- Consult with management regarding important accounting and financial reporting issues that affect UC.



Audit Plan: Audit Approach

Our audit strategy starts at the same point as your business – with your strategies and business objectives. Through discussions with senior and operational management, we understand your business objectives and risks. We then focus our approach on those risks that may materially impact financial statements.

Our “top-down” management discussions not only identify the business objectives and risks, but also key controls in place to manage those risks. We test those management controls. We then determine how we will substantively test significant account balances and classes of transactions.



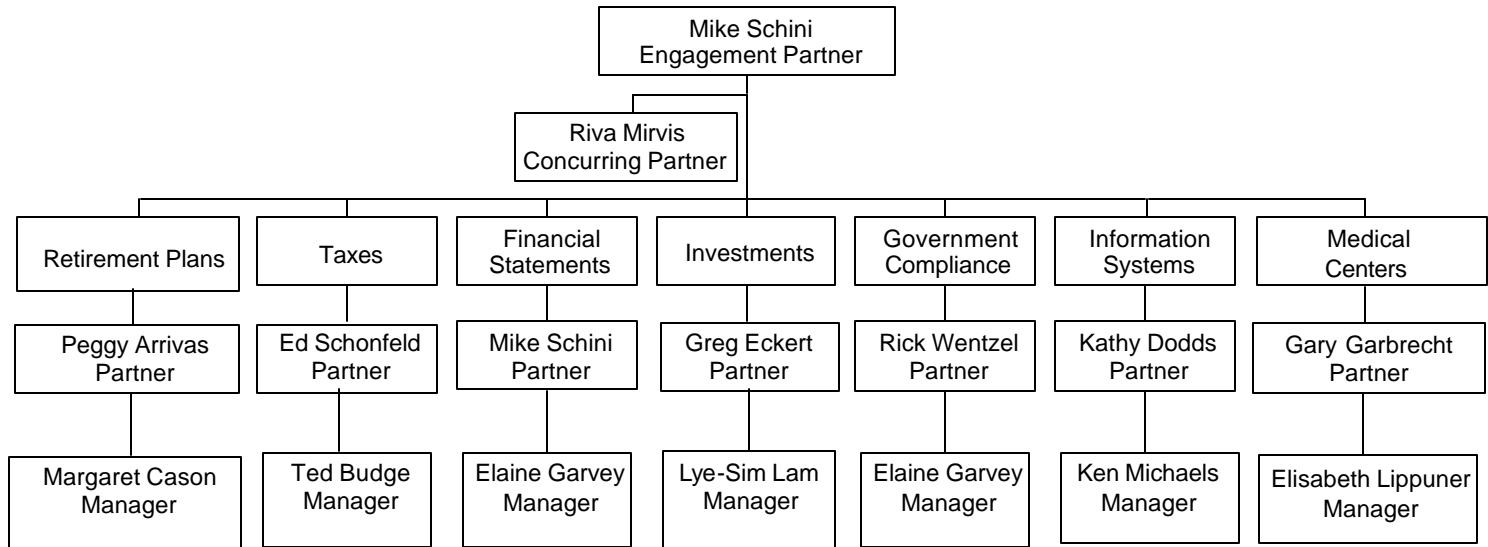


Audit and Reporting Timetable

Planning and coordination	March and February 2004
Audit procedures	May-September 2004
Completion of fieldwork (opinion date)	September 2004
Committee on Audit Meeting	November 2004



Engagement Team





Audit Plan: Audit Approach (related parties)

- New standards and practices require increased emphasis on auditing related party transactions and communicating with the Committee on Audit in this regard.
- UC's controls over related party transactions include maintaining written policies governing related party transactions and transaction authorization procedures.
- Material related party transactions that came to our attention during the prior financial statement audit include appropriations, contracts and grants received from the state of California, of which the University is a component unit for financial reporting purposes; lease obligations to the state financed by the state revenue bonds; contributions received from and assets held by the University on behalf of UC's foundation and investment of the University of California Retirement System which are managed by employees of the University. All such transactions are disclosed.
- The separate medical center financial statements include disclosure of related party transactions with the University.
- Other related party transactions exist including receipts of contributions by members of the Regents, transactions with affiliated entities such as alumni associations, etc. None of these were deemed material for disclosure purposes by management.



New Accounting Standards

During our current year audit, there are two Governmental Accounting Standards Board (GASB) pronouncements that will be considered:

The GASB has issued Statement No. 39, "Determining Whether Certain Organizations are Component Units", effective for years beginning July 1, 2003. Statement No. 39 will require the University's ten legally separate, tax-exempt campus foundations to be presented discretely in the University's financial statements. At June 30, 2003, campus foundations' net assets exceeded \$2.5 billion. Statement No. 39 will be implemented in the current year.

The GASB has also issued Statement No. 40, "Deposit and Investment Risk Disclosures", effective for years beginning July 1, 2005. Statement No. 40 establishes additional disclosure requirements addressing common risks of investments. The Statement will have no effect on the University's net assets or changes in net assets. Statement No. 40 will be implemented in the next fiscal year.

As part of our audit, we will expand our audit procedures to review the presentation of the campus foundations, certain of which are not audited by us, and review the expanded disclosures required under GASB Statement No. 40 in advance of the implementation required next year. Since we are not the auditors of all of the foundations, we will plan to reference the work of the other auditors in our report.



Audit Plan: Risk Analysis

On the following pages, we include our risk analysis for significant components of the financial statements. This risk analysis is intended to highlight some of the areas that we give greater attention to in connection with the financial statement audit. It is not intended to be a complete listing of all risks or all procedures that we perform in connection with our audit. This risk analysis has been developed considering industry issues affecting the University including, but not limited to, increased scrutiny of federal awards, state funding reductions, financial reporting changes and healthcare regulatory issues.

Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Investments (48% of total University assets; 99% of total Retirement System Assets)</p> <ul style="list-style-type: none"> • Are not properly valued • Do not exist • Are not reconciled to manager/custodian records • Contracts, e.g., derivatives, are entered into by University managers without approval and are not known to the University. 	<p>All traded investments are priced using independent pricing services. All non-traded investments priced based upon audit reports, appraisals, pricing models or other available information. Investments are reconciled at least monthly.</p> <p>The University uses strict guidelines to evaluate its managers and evaluates their performance.</p>	<p>We independently reprice a significant portion of all traded investments. All traded investments held by the custodian are confirmed directly with the custodian; non-traded investments are confirmed on a sample basis.</p> <p>We review all significant reconciliations and year end portfolios for evidence of non-recorded transactions and contracts. We confirm pending trades and other liabilities.</p>



Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
Investments (continued)	<p>Management maintains investment guidelines to limit the exposure in particular sectors, to ensure the quality of the investments purchased and regularly reviews performance of its managers.</p> <p>Management has established controls to ensure that purchase and sale transactions are authorized.</p>	<p>We obtain an understanding of the investment guidelines and review, on a limited sample basis, compliance therewith.</p> <p>We review controls over trading activities and obtain SAS 70 reports over the custodian.</p>

Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Plant facilities</p> <ul style="list-style-type: none"> • Are not properly initially recorded at cost • Do not exist • Are not appropriately depreciated. 	<p>There are specific authorizations required for capital projects and reviews of budget to actual performance. Accounts are subject to monthly reconciliations. Capitalization thresholds, depreciable life guidelines are in place. Periodic inventories are performed of moveable equipment.</p>	<p>We obtain an understanding of the policies and procedures over plant. We vouch a sample of fixed asset additions and review year end reconciliations. We recompute depreciation on a test basis and perform analytical procedures over depreciation expense. We review results of physical inventories and reconciliation of subsystem to general ledger.</p>



Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Accounts receivable</p> <ul style="list-style-type: none"> • Are not properly categorized • Do not exist • Are not properly valued or collectible. 	<p>Accounts receivable are subject to review at year end for collectibility. Overdue accounts are investigated.</p>	<p>We review a sample accounts receivable for collectibility issues. We review reconciliation to detail and perform analytical reviews.</p>
<p>Accounts payable and accrued expenses</p> <ul style="list-style-type: none"> • Are not complete or accurate. 	<p>Accounts are reconciled on a monthly or quarterly basis. A year end cutoff is performed to ensure that significant payables are captured.</p>	<p>We perform analytical procedures on balances and review year end reconciliations for all accounts over a given threshold, as well as a sample below. We perform a search for unrecorded liabilities.</p>



Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Other assets and liabilities</p> <ul style="list-style-type: none">• Are not appropriately stated• Are not reconciled or properly deferred.	<p>Reconciliations are subject to monthly monitoring and review by the Controller's office. Large fluctuations are investigated.</p>	<p>We perform analytical procedures on balances and review year end reconciliations for all accounts over a set threshold, as well as a sample below.</p>
<p>Revenues and Expenses</p> <ul style="list-style-type: none">• Not appropriately categorized• Not complete.	<p>Accounts are reviewed monthly for unusual trends. Budget to actual is monitored.</p>	<p>We vouch selected revenues and expenses in connection with other audit areas and complete a separate sample of payroll. We perform analytics of changes in accounts and consider the work completed by internal audit.</p>



Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Notes and bonds payable</p> <ul style="list-style-type: none"> • Are not complete or accurate • Result in non-compliance with terms and conditions. 	<p>Management reviews all agreements for compliance with internal debt policy and covenants. Procedures are in place to ensure payments are made as required.</p>	<p>We independently confirm all significant debt. We review compliance on a sample basis with debt covenants. We review reconciliations to the general ledger, as well as footnote disclosures.</p>
<p>Net assets</p> <ul style="list-style-type: none"> • Are not in the appropriate category • Are not supported by appropriate detail. 	<p>Management produces a year end detail of net assets by category and ensures that this detail reconciles to the financial statements.</p>	<p>We perform analytical procedures on balances and review year end reconciliations. We review a sample of balances to ensure proper categorization.</p>

Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Sponsored research</p> <ul style="list-style-type: none"> • Non-compliance exists which would be material to the financial statements or to federal or state programs. 	<p>Management has extensive policies, procedures and training in place to ensure compliance with sponsored research guidelines. This area also receives internal audit attention and review.</p>	<p>We perform analytical review of revenues and expenses. In connection with the A-133 audit, we examine charges to federal and state awards for compliance with federal and state regulations. We consider results of internal audits and federal regulatory changes.</p>
<p>Hospitals</p> <ul style="list-style-type: none"> • Extensive judgment is required in developing reserves for contingencies and third party payors. • Complex regulations with changing interpretations make compliance difficult. 	<p>Management focuses on reviewing subjective reserves and complying with regulatory issues.</p>	<p>We use separate PwC audit teams who specialize in healthcare. Audit procedures focus on reasonableness of estimates, historical results and consistency in application. Regulatory exposures are considered at each hospital.</p>

Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Financial Reporting</p> <ul style="list-style-type: none"> • Disclosures omitted or not appropriate • Errors made in basic statements in terms of classification or amounts. 	<p>Draft financial statements are subject to numerous internal reviews prior to completion.</p>	<p>We agree the financial statements to the underlying accounting records. We complete a disclosure checklist to ensure all significant disclosures are made and test disclosures back to underlying support. We obtain a legal letter to understand the nature of any potential claims against the University.</p>
<p>Fraud</p> <ul style="list-style-type: none"> • Misappropriations • Fraudulent billings to contracts • Reporting of performance 	<p>Policies, procedures and controls to ensure segregation of duties, compliance with Federal and state regulations, and oversight of managers.</p>	<p>We consider incentives and pressures, have and will continue to expand our interviews, and consider the possibility of fraud in every audit.</p>



Audit Plan: Risk Analysis

Risk Area that could materially affect the Financial Statements	Management Controls	Audit Approach
<p>Information Technology</p> <ul style="list-style-type: none"> • Systems could fail on implementation, resulting in inaccurate data • Security could be breached • Management resources could be distracted based upon time devoted to implementing new systems. 	<p>Management is focused on dealing with issues related to new system. Issues arising are prioritized. Security is considered in implementing new systems.</p>	<p>We will review general computer controls and security as it relates to the general computer environment. Additional resources and time will be devoted in the current year to consider continuing implications of the new systems.</p>
<p>Department of Energy (DoE) Labs</p> <ul style="list-style-type: none"> • Revenues and expenses are consolidated by UC and subject to the risk that amounts are not properly stated. • Contract noncompliance which could be material to the University or could indicate poor financial stewardship of federal resources. 	<p>Management has recently augmented enhanced oversight of all three DoE labs, including reviews of internal control systems, redefined reporting, and strengthened internal audit presence.</p>	<p>We perform a review of selected tests of details and fluctuation analyses. Further expansion in the current year is under discussion.</p>



Perspectives on Fraud Risk



Management:

- Ultimately responsible for developing and maintaining anti-fraud program
- CFO/Controller develop controls to deter and detect fraud
- G.C./Int'l Audit/Compliance: monitoring and auditing

Committee on Audit:

- Evaluate management's identification of fraud risk
- Evaluate implementation of fraud controls
- Reinforce "tone at the top"
- Conduct special investigations

External Auditor:

- Evaluates management's programs and controls to deter and detect fraud (SAS 99)
- Reasonable assurance that financial statements are free of material misstatement due to fraudulent financial reporting or misappropriation of assets (SAS 1, 99)



Appendix 1

Principles & Practices Regarding Our Relationship with Client Audit Committees

Communications plan – Elements

Appendix 2

Communications plan	Framework and protocols for our communications
PwC principles and practices	Statement of PwC's core values and principles
Engagement letter and independence confirmation	Terms of our audit engagement, including fees, expenses and independence
Risk condition alert	Analysis and discussion of risk conditions pertaining to higher risk clients
Corporate governance: roles and practices	Discussion of Committee on Audit, management and auditor roles
Transparency of corporate reporting	Dialogue around clarity, relevance and completeness of client's corporate reporting
Risk analysis	Our view of client risks and their implications on the audit
Perspectives on fraud risk	Discussion of fraud risk from the Committee on Audit's point of view and ours
Our audit plan	Presentation of audit plan, including timetable, approach, business unit scope and other information
Update on accounting/audit issues and risk analysis	Discussion of accounting and audit issues and risks
Internal control and business issues report	Observations and recommendations on client's internal controls and business issues
Best practices in corporate reporting	Discussion of recent trends in corporate reporting
Reporting requirements	Required communications to Committee on Audits; our views on transparency and quality of earnings
Audit opinion	Issuance and review of opinion on financial statements and attestation
Assessing our performance and yours	Dialogue and evaluation of our communications and relationship, including performance of both PwC and the Committee on Audit



Appendix 3

Scope Expansion For the DoE Laboratories



Appendix 3 Scope Expansion for the DoE Laboratories

Options include:

1. Full audit
2. Agreed-upon audit procedures
3. Same expanded scope as last year



Appendix 3 Scope Expansion for the DoE Laboratories Full Scope Audit

- Purpose – opine on presentation of lab financial position under DoE reporting standards
- Assesses internal control as needed to conduct financial statement audit
- Materiality established based upon stand-alone financial statements of each laboratory
- Would be subject to scope limitation or disclaimer or opinion due to security issues (inventories and contract provisions)
- Opinion on balance sheet only since no audit performed in any prior year
- Suggest complete as of 6/30 (UC's year end) to allow for corrective action as needed prior to DoE year end.



Appendix 3

Scope Expansion for the DoE Laboratories Full Scope Audit

- Would focus on two areas not normally subjected to audit coverage:
 - Year end reconciliations
 - Appropriateness of generally accepted accounting principles used by Labs



Appendix 3

Scope Expansion for the DoE Laboratories Agreed-Upon Audit Procedures

- Purpose – move toward full audit, with focus on higher risk accounts, and
- Assess internal control as needed to perform audit procedures
- Would not have opinion issued as product; rather a management report on the results of the procedures with recommendations
- Lower cost and more flexibility
- Could possibly obtain more coverage in the higher risk areas



Appendix 3

Scope Expansion for the DoE Laboratories

Same expanded scope as last year

- Purpose – mainly to detect if major accounts are reconciled – does not involve independent confirmations, etc.
- Given prior year issues, represents minimum needed to complete audit of University financial statements.
- Product would be management letter recommendations



Appendix 3 Scope Expansion for the DoE Laboratories Cost Options

Option 1: Full audit of each of the labs -
\$335,000 plus out-of-pocket expenses

Option 2: Scope and fee to be determined based
upon mutual agreement

Option 3: \$116,500

End



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