October 17, 2003

To The Regents of the
University of California

We have recently completed the audit of the financial statements of the University of California (the “University”) and reported on them, as well as on the separately issued financial statements of related entities, including the University’s five medical centers and Retirement System funds. In planning and performing our audits of the various financial statements of the University, we considered the University’s internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. As part of our audit, we made a study and evaluation of the University’s system of internal controls to the extent we considered necessary to evaluate the system as required by auditing standards generally accepted in the United States of America. Although our audit was not designed to provide assurance on the internal control structure and its operation, we noted certain matters that we are submitting for your consideration designed to help the University make improvements and achieve operational efficiencies.

As in prior years, we issued separate letters with our comments and recommendations to each of the campus chancellors and laboratories. The comments contained in this letter are summaries of those comments which generally represent common themes across the campuses and laboratories, or are significant. Management at the campuses, medical centers and laboratories have responded and, where appropriate, are taking corrective actions to our comments. The full text of all our comments is contained in separately issued letters and available under separate cover.

Our comments reflect our desire to be of continuing assistance to the University. We look forward to discussing these matters with you at the November 2003 Regents meeting. Please contact Michael Schini at (408) 817-4478 if you have any questions regarding this report.

This letter is intended solely for the information and use of The Regents’ Committee on Audit, management and others within the University.

Sincerely,

[Signature]
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CURRENT YEAR COMMENTS

UNIVERSITY-WIDE

1. Consider Use of Build-up Certifications

Observation

As a result of the passage of the Sarbanes-Oxley Act, many SEC companies have had to make changes to their controls and processes to strengthen their closing processes so that there is appropriate support for the quarterly and annual certification of financial information provided to the SEC in periodic filings. While the University and the campus are not subject to the Sarbanes-Oxley Act, and are therefore not subject to these certification requirements, they do nonetheless provide important financial information in the University's Annual Report.

In recognition of the stricter standards of the Sarbanes-Oxley Act, the Office of the President (OP) has begun to introduce a build-up certification process in that it requires that the campuses and medical centers provide a copy of the annual representation letter to the external auditors to OP 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 that 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. For example, in the year-end representation letter, OP will assert that all pledges are properly recorded, to the best of its knowledge and belief. To properly make this representation, it is assumed that OP has reasonable knowledge of its practices and policies and of any specific issues. As such, there is the expectation of some reasonable level of diligence, perhaps demonstrated by obtaining an internal representation letter, relative to pledges.

Recommendation

While OP has begun to use the build up process from the campuses and medical centers, the campuses have not generally begun to do so. We have recommended to OP to continue to review the build-up certifications required and recommended that OP encourage all campuses to give consideration to requiring build up certifications, as deemed appropriate by management, as a basis for signing the campus representation letter.

Management’s Response

Financial Management in the Office of the President concurs. In conjunction with the Management Representation Letter process for 2004, it will work with the Campus Controllers to develop an approach and implement build-up certifications in key areas such as Development, Research, etc.
MEDICAL CENTERS

2. Third Party Settlement Accounting Documentation Standards and Consultation with Legal Counsel

Observation

The Medical Centers participate in the Medi-Cal and Medicare programs and accordingly are subject to the Rules and Regulations promulgated by the Centers for Medicaid and Medicare Services (“CMS”). One of the conditions for participating in these programs is that the Medical Centers file required annual cost reports. These cost reports establish the level of reimbursement based upon services provided to the recipients of these programs. The Medicare cost reports and the rules and regulations governing allowable/reimbursable costs are complex and in many cases subject to wide interpretation.

The Medicare cost reports are audited by a third party fiscal intermediary contracted by the CMS, with retrospective settlement. The fiscal intermediary for the University of California Medical Centers is United Government Services (“UGS”). UGS audits have resulted in asserted, proposed or final adjustments with both retrospective and prospective financial and reimbursement implications. Some of the more significant adjustments have resulted from differences in interpretation of rules and regulations, or required supporting documentation. To the extent such adjustments are asserted, proposed or otherwise finalized, management evaluates the need to accrue loss contingencies pursuant to Financial Accounting Standard No. 5: Accounting for Contingencies and Statement of Position No. 00-1 Auditing Healthcare Third Party Revenue and Related Receivables. As a result of these asserted claims, the Medical Centers have recorded significant loss contingencies. Development of these reserves requires considerable judgment, including an assessment of the probability of an unfavorable outcome. The documentation maintained by the Medical Centers should be supportive of the accruals made, while at the same time not compromising the Medical Center’s legal and contractual rights. As such, legal counsel is often involved in reviewing documentation and discussions of positions taken in these matters.

Recommendation

We have recommended to the Medical Centers that they consider involving counsel, in collaboration with Medical Center Financial Management, to advise the Medical Centers on the review and/or development and implementation of formal policies and procedures that would provide consistent guidance for the Medical Centers on the implementation, development and recording of loss contingencies associated with the cost reporting process. We believe this policy should specifically address related documentation approach and standards.
2. Third Party Settlement Accounting Documentation Standards and Consultation with Legal Counsel (continued)

*Management’s Response*

This observation and recommendation was made at all five of the Medical Centers. University management and the Office of the General Counsel concur. The Office of the General Counsel, in conjunction with financial management and counsel at the medical centers, will collaborate to review, develop and implement formal policies and procedures that will provide consistent guidance on the implementation, development and recording of loss contingencies associated with the cost reporting process.

3. Consider Performing an Independent Physical Inventory of Capital Assets at Certain Medical Centers

*Observation*

We understand that the University of California has a policy and prescribed procedures that govern the periodic physical inventory of capital assets. Generally, we understand that the process by which the Medical Centers conduct the physical inventory is for each department manager to be provided a copy of their department’s capital asset listing with instructions that direct the department manager to count the assets and report discrepancies, if any. Further it is our understanding that the consistency, responsiveness and accuracy of the physical inventories vary between Medical Centers and between departments within a given Medical Center. Variability in such practices may expose the Medical Centers to misstatement of the reported net book value of capital assets, and may prevent detection of losses. Given the inherent complexities involved with coordinating and conducting a physical inventory of capital assets on a scale the size of that associated with the Medical Centers, it is common industry practice to engage an inventory specialty firm every several years to conduct an independent physical inventory of the Medical Centers capital assets.

*Recommendation*

We have recommended to certain of the Medical Centers that they take steps to improve their capital asset physical inventories. These actions could range from a more effective internal effort or the adoption of the common industry practice of engaging an outside inventory specialty firm to perform an independent physical inventory. Such actions are necessary to ensure the completeness, accuracy, and existence of recorded capital assets. This would assist management in ensuring proper financial reporting, capital budgeting, and in determining the proper level of insurance coverage. In the event outside resources are used in this effort, we recommend that such outside inventories be performed periodically on a go forward basis.
3. Consider Performing an Independent Physical Inventory of Capital Assets at Certain Medical Centers (continued)

Management’s Response

This observation and recommendation was made at three of the five Medical Centers (UCLA, UCSF and UCD). Each of the Medical Centers recognize the importance of maintaining strict inventory control over their capital assets and agree to enhance and emphasize procedures to increase the integrity over the process. This will likely be accomplished through internal resources this year rather than engaging outside resources.
DOE LABORATORIES

4. DOE Reporting

Observation

During our audit procedures at the Labs, we noted that only a few accounting personnel have a good understanding of the link between the Lab’s financials to the Department of Energy (“DOE”) financials or on how the information flowed or mapped from the general ledger to the Management and Accounting Reporting System (MARS), or DOE, accounts. In addition, there was not a good understanding of the accounting principles employed by DOE and why certain costs are deferred or expensed. For example, it was not well understood why the pension plan overfunding was maintained in the DOE balance sheet. Without proper understanding of DOE reporting and the accounting principles used by DOE, errors may result simply due to a lack of understanding or knowledge about DOE reporting. Also, this lack of understanding may result in an inefficient and burdensome review process for client management as well as during external audits.

Recommendation

We have recommended to the Labs that they implement a training course for their accounting or finance staff to attend so that they may better understand the relationship between the Lab’s general ledger and the DOE financials, as well as to understand the individual DOE journal entries that are provided by the DOE to be booked by the Lab on a monthly or quarterly basis.

Management’s Response

This observation and recommendation was made at the three DOE National Laboratories. Management at all three laboratories indicate their concurrence and are developing plans to provide the recommended training for the appropriate personnel.

5. Reconciliation of DOE Trial Balance at the Lawrence Berkeley Laboratory

Observation

During our audit procedures at the Lawrence Berkeley Laboratory, we noted that monthly reconciliations between the Lab’s general ledger to MARS accounts (DOE accounts) were not being performed. Failure to prepare formal MARS account reconciliations on a timely basis could have various adverse implications ranging from significant reconciling items going undetected by management to improper financial reporting to the DOE.
5. Reconciliation of DOE Trial Balance at the Lawrence Berkeley Laboratory (continued)

Recommendation

We have recommended to the Lab that a standard, formal MARS account reconciliation be performed on a monthly basis. Furthermore, management should review the reconciliations on a timely basis to ensure proper reporting or classification of general ledger accounts are performed.

Management’s Response

LBNL concurs with the recommendation. Management recognizes the importance of timely account reconciliation, including the MARS account reconciliation. Formal procedures that set forth account reconciliation requirements and standards will be developed and in place in the first quarter of fiscal year 2004.


Observation

In reviewing the process surrounding manual journal entries, we noted that, at all Labs, the recording of manual journal entries provided by the DOE was not subsequently reviewed for processing accuracy. For example, a monthly entry to record the Lab’s environmental liability was recorded into the general ledger based on either a faxed or e-mailed summary letter from DOE. Furthermore, it was not well understood how the environmental liability amount was calculated or derived and what accounting principles were used by DOE. In addition, there was no evidence that the manual entries were approved and reviewed by management. Without proper review of journal entries, management may not be aware of the accuracy and validity of entries made to the general ledger and included in the Lab’s financial statements. Furthermore, the risk of error exists for all accounts with manual entries.

Recommendation

We have recommended that Management should develop, document and communicate formal policies and procedures addressing the adequacy of support, review requirements and retention procedures for journal entries. All journal entries should be properly controlled, adequately supported and should show evidence of appropriate review and approval.

Management’s Response

This observation and recommendation was made at the three DOE National Laboratories. Management at all three laboratories concur. Management has indicated that it will obtain additional supporting documentation on how the liability is derived, develop formal policies and procedures and implement a review and validation for manual journal entries.

7. Reconciliation of Inventory Accounts at the Los Alamos Laboratory

Observation

During our review of inventory accounts at the Los Alamos National Laboratory, certain inventory accounts totaling approximately $53MM relating to the weapons production have not been tracked accurately since approximately 1999. The total weapons inventory at June 30, 2003 was approximately $417MM. Management was unable to provide validation or supporting details for the fiscal year-end balances. In addition, we noted that there was a significant purchase price variance adjustment totaling approximately $2.3MM, which the Lab was unable to identify the cause of the adjustment. Without performing timely reconciliation and valuation of inventory at least once a year, the Lab’s financial statements may be misstated and potential errors may not be identified and resolved.

Recommendation

We have recommended that the Lab perform a full physical inventory count of all weapons inventory. We also recommend that the Lab establish formal inventory count procedures. Procedures should also include coordinating policies for inventory valuation and reconciliation of differences between book and physical inventory.

Management’s Response

LANL Management concurs. The Lab has completed an initial review of the Weapons Production area and has adjusted its general ledger accordingly. These adjustments were made based upon a physical inventory and standard costs developed for each part.
8. Reconciliation of Payroll and Benefits Accounts at the Berkeley Campus

Observation

During the course of our audit at the Berkeley campus, we noted that reconciliations are not performed consistently between the general ledger and the payroll system. Many of these accounts remained unreconciled at the year-end. The unreconciled accounts related primarily to retirement liabilities and health liabilities. The total payroll and benefit accrual at June 30, 2003 was approximately $78 million.

In addition, we noted that a high volume of debit balances within the accrued salary and payroll accounts. These related primarily to health insurance accounts.

Recommendation

Reconciliations are a key control to enable management to identify errors, fraud and unusual items on a timely basis. The lack of reconciliation increases the risk that errors or fraud may not be identified and investigated and may result in a material over or understatement of liabilities. In addition, reconciliations should always be reviewed by another member of staff to ensure the accuracy and completeness of the reconciliation and the appropriate follow up on any unusual items identified.

We recommend that payroll and benefit accounts sub-ledger accounts are reconciled and to the general ledger and reviewed on a monthly basis.

In addition, we recommend that management review the account breakdown of the balances and ensure that all debit balances are reviewed and cleared as soon as possible.

Management’s Response

Berkeley campus management concurs. Payroll will establish a reconciliation process for the accounts on a routine basis. A review of the current balances is underway, and they anticipate having a plan to reconcile the accounts in the near future.
APPENDIX
STATUS OF PRIOR YEARS COMMENTS

Management takes the responsibility for tracking the implementation status of prior year management letter comments. We are informing you of management’s progress in implementing the prior year recommendations that were not yet implemented.

COMMENT ORIGINATING IN FY02:

University-Wide

Continue The Process Initiated In The Spring For Implementing GASB Statement No. 39, “Determining Whether Certain Organizations Are Component Units” Implemented

Improve Accrual Cut-Off Process Implemented

Medical Centers

Maintain Awareness Of Changes In The Regulatory Environment Implemented

Continue Monitoring Health Insurance Portability And Accountability Act Regulation Modifications

COMMENTS ORIGINATING IN FY01:

Medical Centers

Continue Efforts To Ensure The Medical Centers’ Compliance With HIPAA In Progress

COMMENTS ORIGINATING IN FY00:

University-Wide

Professional Fee Billing And Corporate Compliance Program In Progress

Research Compliance Program In Progress

Medical Centers

Assess HIPAA Readiness At Each Medical Center In Progress