

The Regents of the University of California

COMMITTEE ON AUDIT

November 19, 1998

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

Members present: Regents Clark, Connerly, Davies, Khachigian, Parsky, Sayles, and Villaraigosa

In attendance: Regents Atkinson, Bagley, Chandler, Espinoza, Hotchkis, Johnson, Kozberg, Leach, Lee, Miura, Montoya, Nakashima, Ochoa, Preuss, and Willmon, Regents-designate Taylor and Vining, Faculty Representatives Coleman and Dorr, Secretary Trivette, Associate Secretary Shaw, General Counsel Holst, Treasurer Small, Provost King, Vice Presidents Broome, Darling, Gomes, Gurtner, Hershman, and Hopper, University Auditor Reed, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Dynes, Orbach, and Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 11:30 a.m. with Committee Chair Sayles presiding.

1. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 1998**

In accordance with the Schedule of Reports, the **Annual Report of External Auditors for the Year Ended June 30, 1998** was submitted for discussion.

The Committee was informed that the objective of The Regents' external auditors in performing the basic University audit is to render an opinion on the general purpose financial statements of the University of California. In addition, the auditors report their observations and make recommendations with regard to accounting procedures and controls. The report on the audit for the year ended June 30, 1998 was prepared by Deloitte & Touche LLP, external auditors of The Regents. Deloitte & Touche also prepared year 2000 compliance letters and the management letters which are issued to each campus and to the Office of the President, containing the auditors' observations and recommendations on each location and management's response.

Prior to calling upon the representatives from Deloitte & Touche, Senior Vice President Kennedy gave a brief update on the implementation of management letter recommendations from prior year audits. He recalled that over the past two years, Deloitte & Touche has communicated to senior management a number of recommendations from an overall University perspective as well as from a campus and medical center perspective. These recommendations have either been implemented or are in the process of being implemented. The University's administration has made significant improvements in its business programs to strengthen accountability and controls throughout the University. A clinical enterprise reporting model is being developed, and Vice President Gurtner has established a

Universitywide compliance committee to develop a medical center compliance program. The administration has strengthened policies for information security, new systems development, and business continuity planning. Year 2000 compliance is a high priority for the campuses and the Office of the President, and plans are in place to evaluate, certify, replace, or modify and test key systems for year 2000 compliance. Mr. Kennedy noted that the Regents have been kept abreast of these efforts through periodic reports by Associate Vice President Lynn.

Vice President Kennedy called the Committee's attention to the development of the controller position at each of the campuses and in the Office of the President. He recalled that he had recently reported to the Regents on the initiation of the Business Officer Institute and Certification program, which provides essential training to academic business officers and others in key administrative roles throughout the University system. While much has been accomplished to improve business systems and enhance the level of accountability, the work is in progress.

Mr. Rich Fineberg, managing partner for Deloitte & Touche, recalled that two years ago, following the completion of the firm's first audit of the University, he had reported to the Committee that significant control challenges faced the University. These challenges were discussed in great detail with Senior Vice President Kennedy and other members of the management team. The external auditors acknowledge that progress has been and continues to be made in strengthening the financial systems and the environment for controls within the University.

Mr. Bob Shapperle, lead client service partner, presented Deloitte & Touche's comments on the external audit of the University's financial statements for the year ended June 30, 1998. He reported that Deloitte & Touche's opinion of the financial statements is unqualified and free of any exception, which means that they have been fairly presented in conformity with generally accepted accounting principles. No adjustments were required as a result of the audit, and there were no adjustments at any location, either individually or in the aggregate, that exceeded \$5 million in their effect on University operations. The 1998 financial statements include the nine campuses, the four medical centers, the University of California Retirement System, and the Department of Energy Laboratories. The UCSF medical center is reflected as an investment as a result of its merger with Stanford Health Services. As discussed with the Committee when the external audit plan was approved last spring, Deloitte & Touche reviewed a number of areas in the financial statements; the external auditors took no exceptions with the accounting or the estimates that were made by management. During the year ended June 30, 1998, there were no significant changes in previously adopted accounting principles or in their application. Accounting estimates are an integral part of the general purpose financial statements prepared by management and are based on management's current judgments. Significant accounting estimates reflected in the University's 1998 general purpose financial statements include reserves or allowances for or related to the University's self-insurance programs, third-party settlements, doubtful accounts, and contractual discounts. Deloitte & Touche is not aware of any significant changes in

accounting estimates or in management's judgments relating to such estimates. Mr. Schapperle reported that Deloitte & Touche had no disagreements with management in connection with the audit and received the full cooperation of the University's management in performing the audits. With respect to internal control, Deloitte & Touche gained a better understanding of the University's system of internal accounting control and determined that there were no material weaknesses.

Mr. Schapperle noted that the management letter contained three sections, and he addressed the first one, **Accountability and Control**. Over the past two years, management has initiated or substantially enhanced a number of programs and activities that have strengthened the control environment within the University. These initiatives and enhancements have included the following:

- Establishment of a Director of Financial Control or Controller at each campus to provide leadership for campuswide initiatives.
- Development and implementation of a number of control initiatives at the campuses, including an ongoing process of risk self-assessment.
- Implementation of the Business Officers Institute, a training program for management services officers which emphasizes strong financial management and accountability and control.
- Strengthened leadership at the Office of the President for directing and coordinating systemwide control initiatives.

Mr. Schapperle reported that these initiatives have had a positive effect as they manifest themselves in the financial reporting process. As part of the audit over the past two years, Deloitte & Touche has noted the following:

- A heightened commitment to accurate financial reporting.
- Increased accountability for the accuracy of elements and accounts contained in the financial statements.
- A commitment on the part of campus leaders to a process to follow up on the auditors' observations and recommendations for improvements in the overall internal control framework.
- An increased awareness and acceptance of the benefits of a strong control environment.

The University's objective is a self-sustaining process that identifies major risks, establishes processes to mitigate those risks, and monitors and adjusts those processes as necessary.

Mr. Jack Krouskup, client service partner for the University's medical centers for Deloitte & Touche, reported that the **Clinical Enterprise Organization Matters** section of the management letter addresses the issues of Clinical Enterprise Reporting and the Control and Compliance Function within the Medical Centers. Three additional areas which were included in last year's report--physician billing, contractual allowances and managed care contracting, and the quarterly review process--were not discussed because of the progress that has been made. Mr. Krouskup recalled that over the past few years a clinical enterprise reporting task force had developed a clinical enterprise reporting model intended to provide a consistent reporting methodology for the four medical centers and their related campuses. Operations reporting is in the process of being implemented, with financial condition information scheduled to be available in 1999. Deloitte & Touche believes that these efforts will produce relevant financial information for the use of University management.

Mr. Krouskup noted that compliance programs are increasingly important to healthcare organizations. The University has recognized their importance by appointing a Universitywide Compliance Committee. The committee's first activity was to develop Universitywide compliance guidelines for professional billing. The campuses subsequently developed and adopted Professional Fee Billing Campus Compliance Plans to implement these guidelines. More recently, the University has been in the process of finalizing Guidelines for the Health Sciences Clinical Enterprise Corporate Compliance Program. These guidelines will address a broad range of issues, including standards of conduct, quality of care, medical necessity, and coding and billing. At the same time, compliance committees are developing campus-specific corporate compliance plans and an ongoing monitoring process; these will be implemented in 1999. The University is devoting significant resources to these important matters.

Mr. Schapperle discussed the **Business Systems Issues** section of the management letter, which covers the topics of the Business Systems Development and Maintenance Cycle, Information Security Guidelines, and Disaster Recovery and Information System Continuity Planning. He recalled that last year the auditors had noted that the Office of the President was preparing a set of system development standards to be followed throughout the University; these standards were issued in fiscal 1998. As part of the current audit, Deloitte & Touche made high-level inquiries and found that some information systems departments had adopted the standards and that the development and programming staff were aware of them. At other departments, however, there was an inconsistent understanding of the new standards or a lack of awareness of their existence. In the management letter, Deloitte & Touche has recommended that the University, through the campuses and medical centers, provide additional training and education to systems development personnel to enhance their understanding of these standards.

With respect to information security guidelines, Mr. Schapperle recalled that last year the external auditors recommended that the University evaluate and modify, as necessary, existing information security guidelines. As a result, new security guidelines have been developed and were recently issued to the campuses. During the course of the 1998 audit, the external auditors made inquiries about the current information security practices; where appropriate, comments have been included in the separate letters to the chancellors. Although the inquiries indicated security awareness in general is high, additional attention is required for enhanced security within the distributed network systems, such as the deployment of "firewalls" around the restricted application systems and controls to prevent the transmission of unencrypted passwords, thus improving security. Although firewalls are employed within the Office of the President, few of the campuses and medical centers use this technology. Secondly, passwords are not encrypted when transmitted across the system. As a result, user log-on identification and passwords can potentially be used to gain unauthorized access to University systems.

Mr. Schapperle reported that this year's audit focused on the University's information technology disaster recovery planning. While plans generally exist at the campuses and the medical centers, routine testing in general is not performed, and most campuses and medical centers do not have alternate processing arrangements in the event of a complete system outage. The University's draft information security guidelines will require campus-specific contingency plans, and Deloitte & Touche encourages early implementation of these requirements.

Mr. Schapperle noted that Deloitte & Touche had prepared a separate management letter which describes a series of limited inquiries into year 2000 issues. The observations of the external auditors are generally consistent with the report which was provided to the Regents at the September meeting. Although there are a large number of financial systems affected by the year 2000, inquiries were performed primarily on financial and administrative systems that affect the amounts and disclosures in the financial statements. The auditors found that the Office of the President's Information Resources and Communications Department has developed a work plan to address year 2000 issues over financial and administrative systems. The auditors recommend continued attention to the work plan, as well as ongoing funding of the remediation efforts. With respect to other systems, the auditors found that although preliminary assessments have been made and mission-critical systems have been identified, the progress is not as far along as would be desired. The auditors therefore recommend the development of remediation plans for all mission-critical systems.

In response to a question from Regent Clark, University Auditor Reed explained that the head of the audit department on each campus typically will have the title of Audit Director and will report to the Vice Chancellor for Administration. At the recommendation of Deloitte & Touche, a parallel position, titled Director of Financial Control or Controller, was established at each campus to provide administrative leadership. This position also reports to the Vice Chancellor for Administration. Mr. Schapperle continued that one of the responsibilities of

the Controller is to establish a system of controls at the campus level, while the Audit Director is responsible for monitoring those controls and providing suggestions as to potential improvements to these controls.

Regent Clark commented that it was common for a controller to be involved in internal audit activities and suggested that the model developed by the University was a confusing one. He noted that the chief financial officer should have the responsibility for the overall organization of everything which pertains to financial matters, including internal audit. Regent Sayles observed that Regent Clark was pointing out that it appears that there is no point where systems and auditing come together at a single point of accountability.

In response, Vice President Broome reiterated the fact that at each campus a Controller or a Director of Financial Control is responsible for the financial operations on that campus. This position is not referred to as the chief financial officer because that title infers a treasury function, which is handled separately at the University. She noted that management is responsible for appropriate control systems on every campus. The controller position has become the focal point for those systems. While internal audit also focuses on systems, its primary function relates to assuring management that the systems of control are in place. Vice President Broome reported that the administration is working on a statement of responsibilities for the two functions and offered to provide the members of the Committee with a copy of that report.

In response to a question from Regent Parsky, Mr. Schapperle confirmed that the auditors had no further recommendations to make pertaining to this area.

Regent Clark recalled that the management letter contains the following statement pertaining to the business systems development and maintenance cycle: "As a result of our inquiries, we noted that several information systems departments had adopted the Standards and the development and programming staff were aware of them. At others, however, there was inconsistent understanding of the new standards by the development and programming staff or a lack of awareness of the existence of the Standards." He asked how this could be the case. Mr. Schapperle responded that all of the chief information officers had participated in the task force which established the standards. Deloitte & Touche performed its reviews at various times throughout spring and summer 1998, but full dissemination and training of the standards in some instances had not been performed at the programming staff level. He stressed that further training and development is taking place to ensure a full understanding of the standards throughout the system. Regent Clark suggested that this background information should have been included in the management letter.

Regent Davies drew attention to the following paragraph in the management letter to Chancellor Bishop:

With respect to the four recommendations made as part of the June 30, 1997 audit in our prior year letter, three are not applicable as a result of the merger of the medical center with Stanford Health Services, and one.

Mr. Schapperle stated that the paragraph should have concluded by stating that “and one is still in the process of being implemented.”

In response to a question from Regent Lee, Mr. Schapperle stated that the external auditors had not made inquiries with respect to the year 2000 problem at the medical centers. Associate Vice President Lynn continued that the four medical centers are reporting to the systemwide administration on medical information systems and on the status of medical instruments. He emphasized that the medical centers are addressing the problem seriously and remediation is occurring.

In response to a question from Regent Leach regarding the University’s preparedness for the year 2000, Mr. Schapperle reported that the auditors had gone over the information which Associate Vice President Lynn had received from the campuses and then used that data to make limited inquiries of the chief information officers. No testing was performed of the remediation that was under way. Based on these inquiries, the auditors found that the University has taken the right steps by taking inventory, identifying mission-critical systems, developing a plan for replacement, and identifying funding sources and resource needs.

Senior Vice President Kennedy reported that the State Auditor is in the process of reviewing the University’s Y2K compliance and that a report on that review would be made to the Board.

Regent Sayles pointed out that the Regents would need to decide whether a full audit of the University’s Y2K preparedness would be necessary. In response to a comment by Regent Lee regarding the need for ongoing reports on Y2K preparedness, Regent Sayles noted that while such reports would be ongoing, they would fall under the jurisdiction of the Committee on Finance. The issue he was raising was whether the Regents should request a full-scale audit.

Regent Leach stressed that the Regents and the administration should not mistake activity for accomplishment. He suggested that the Regents should charge Vice President Kennedy and each of the chancellors and laboratory directors with making sure that the University is addressing this problem adequately. He did not believe an audit was called for as long as the problem is being addressed.

Senior Vice President Kennedy recalled that at the September meeting Associate Vice President Lynn had given a detailed report on the University’s response to the Y2K problem. The administration is confident that the University’s mission-critical systems are in good shape. He stated his intention to continue to bring reports on the Y2K problem to the Board.

Associate Vice President Lynn added that the problem is being taken seriously by the campuses and reiterated Mr. Kennedy's impression that the campuses are well prepared in terms of their mission-critical systems.

Regent-designate Vining requested that Deloitte & Touche share with the Regents the campuses' responses to issues raised in the management letters.

Mr. Schapperle noted that Deloitte & Touche gives a tally in the annual audit of how many of the issues it had raised in the prior years' management letters had been addressed. He believed that the level of attention to these matters was high.

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

2. **APPOINTMENT OF EXTERNAL AUDITOR FOR THE YEAR ENDING JUNE 30, 1999**

The President recommended that the current external auditor of the University of California, Deloitte & Touche LLP, be reappointed as external auditor for the fiscal year ending June 30, 1999 and that the fee for the audit program be \$1,250,000 plus estimated expenses not to exceed \$150,000.

It was recalled that at the January 1996 meeting of The Regents, after a formal bid and proposal process, Deloitte & Touche LLP was appointed as The Regents' external auditor for a three-year period beginning with the 1995-96 fiscal year. This three-year period ended with the 1997-98 fiscal year. The expectation during the bid and proposal process was that the firm selected would be retained beyond the initial three-year period if the service rendered was judged to be satisfactory.

Deloitte & Touche has indicated that the firm has been able to gain efficiencies and reduce the required number of hours to perform the annual audit. However, the hours required are still approximately 15 percent in excess of those contemplated in the initial bid three years ago. Over the last three years, Deloitte & Touche LLP has received annual increases in audit fees based upon the Consumer Price Index, together with a \$75,000 reduction due to the UCSF Medical Center leaving the University. The fees for the fiscal year ending June 30, 1998 were \$1,090,000 plus out-of-pocket expenses not to exceed \$92,000.

Regent Clark believed that the level of the auditors' performance would be improved if the contract were put out to bid every three years, as was intended when they were initially appointed.

Senior Vice President Kennedy stressed that management believes that Deloitte & Touche has performed at a more-than satisfactory level over the past three years. With the

concurrence of the Chair of the Committee on Audit, he discussed the audit engagement and the associated audit fees for the 1998-99 fiscal year with the firm. Mr. Kennedy noted that changing external auditors represents an expense for the University.

Regent Connerly supported Regent Clark's position that retention of the external auditors should be exposed to the marketplace on a regular basis.

Regent Sayles pointed out that there is a learning curve for new auditors which makes changing auditors quite expensive and supported the retention of Deloitte & Touche for the coming year.

Regent Leach believed that the University had been exceptionally well served by Deloitte & Touche. He recalled that problems which were uncovered by the external auditors in their first years working for the University had led to substantial improvements in the way in which the University does business. In addition, Deloitte & Touche devoted twice as many hours during their first-year audit as the firm had anticipated with no additional cost to the University. Even with the increase being recommended, the fee is approximately 60 percent of what the University paid its former external auditors for a lesser-quality performance. He cautioned against going out to bid too frequently.

Regent Davies informed the Committee that when he discussed the matter with Senior Vice President Kennedy, consideration was given to rebidding the external audit after three years. The decision was made not to make this recommendation to the Board. His recollection was that the intention was to consider every three years whether or not there should be a new bid.

Regent Clark suggested that this information should have been included in the material that was submitted with the recommendation.

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

3. **REPORT ON EXTERNAL REVIEW OF INTERNAL AUDIT PROGRAM**

University Auditor Reed recalled that at the July meeting of the Committee he had announced that a review of the internal audit program had been initiated at the suggestion of Regent Leach. The review had a comprehensive scope, addressing such issues as structure and lines of reporting, staffing, cost effectiveness, and efforts to strengthen and set the future direction of the program. Before calling upon members of the review team to present the report, Mr. Reed acknowledged the support and encouragement for the review from the entire University community. The review team recognized the need to learn about the University of California as a whole in order to make its assessment. Through interviews with management, the review team was able to gain an important perspective on the environment in which the audit program operates. Mr. Reed noted that the review team also spent a significant amount of

time with the audit directors from each campus and DOE laboratory, and he recognized the presence of the audit directors at the meeting. He acknowledged that any strengths or positive directions in the audit program in recent years are due to the diligence and collaborative efforts of this group of people and their willingness to move forward together.

The University was fortunate to engage for the review a group of professionals who span the external and internal audit professions and several industries. This approach brought a unique combination of knowledge, skills, and perspectives to the audit review. Mr. Reed then introduced the two members of the review team who would present the report. Mr. Robert B. Hirth, Jr. is a partner with Arthur Andersen in San Francisco where he is responsible for internal audit services for the western region. Mr. Anthony J. Ridley is retired as general auditor for Ford Motor Company and a past chairman of the Board of Directors of the Institute of Internal Auditors. Not present were Mr. Michael J. Barone, a director of internal audit services with Price Waterhouse Coopers; Mr. Franklin H. Federmann, the director of internal audit for Brookhaven National Laboratory; and Mr. Robert T. Forrester, a Price Waterhouse Coopers partner in charge of regulatory practice for academic medical centers and educational institutions.

Mr. Hirth reported that the review team considered the dual reporting arrangements in which each of the local audit directors reports jointly to the chancellor or laboratory director as well as to the University Auditor, who reports to the Senior Vice President--Business and Finance and to The Regents' Committee on Audit. Considering the current geographic structure of the University and its overall culture and environment, the review team is of the opinion that this dual solid-line reporting is an effective alternative which adequately meets the needs of the University's administration and preserves the independence of the internal audit program. The review team studied the adequacy of audit resources and determined that the overall annual expenditure by the University for internal audit services is within the acceptable range. There are, however, disparities between the campuses in the number of auditors and amounts spent on auditing. The team found that the quality of the internal audit resources is good and continues to improve, with an active recruiting program and enhanced training programs. The internal audit program is focused both on the skills which are currently required by auditors and the skills which will be required in the future. The review team noted a high level of satisfaction from the University administration with the role and the results of the internal audit program.

Mr. Ridley commented that the review team's overall assessment of the quality and professionalism of the internal audit program was that it was of very high quality. The review team began its study by familiarizing itself with the previous review conducted in 1987 by Arthur Andersen and reviewed the implementation plan and activities subsequent to that review. It was noted that substantial effort was devoted to implementing the recommendations which resulted from the Arthur Andersen review. With respect to the dual reporting structure of the audit program, Mr. Ridley reported that the review team studied

and debated the issue of reporting and came to the unanimous conclusion that the dual reporting structure was the most effective considering the University's current organization.

Mr. Hirth presented the major recommendations which resulted from the review team's work. The first is to raise knowledge sharing and teamwork to the next level. The team believes that effective and fair ways to share resources should be considered and developed in light of the broad base of specialized skills which is needed by every audit department. Secondly, by its size and nature, the University's internal audit program operates with limited resources with respect to the quantity and scope of audit work which can be accomplished in a given year or over a specified time period. The team therefore recommends that the audit program should prioritize key initiatives, assign responsibility, and formally measure the progress of each of the key initiatives to help ensure their timely and successful completion. The third recommendation focuses on the enhancement of the risk assessment process and methodology because the cornerstone of an effective internal audit plan is a process that identifies the business risks facing an organization.

Mr. Hirth recalled that the University had recently created a new internal control-related position of campus controller, which the review team believes is important and correct. The team has made several recommendations to help clarify the respective roles and responsibilities of the controller and internal audit. The fifth recommendation pertains to further refinement of the roles and responsibilities of the local audit committees in order for them to be more effective. Finally, the review team suggests that the internal audit program continue to work on identifying the specialized skills that are needed to be effective and to consider which of those skills should be developed in house and which should be sourced from the outside.

Mr. Ridley noted that all of the recommendations had originated in the internal audit departments. They mirror the challenges which face the audit profession as a whole, including the fact that skill levels are difficult to sustain. A key to success is the establishment of priorities. Mr. Ridley suggested that the Committee might wish to engage another review team in the future to assess what progress has been made with respect to the implementation of these recommendations.

In conclusion, Mr. Hirth reported that the review team found that the University's internal audit program is effective in meeting the needs of the Board of Regents, local management, and the Office of the President. The team's recommendations have been discussed with the University Auditor, and action plans are being developed to implement these recommendations.

In response to a question from Regent Leach regarding the quality of the University's internal audit departments, Mr. Ridley stated that the review team would place them in the top quartile. Regent Leach asked whether it would be appropriate to have the University Auditor provide a report to the Chairman of the Committee on how the audit departments have responded to the review team's recommendations. University Auditor Reed responded that the intention is to formulate a revised strategic plan which will be commented upon in his quarterly report to the Regents.

In response to a question from Regent Montoya, University Auditor Reed stated that he would ask the review team to return within the next year to consult on the implementation of the team's recommendations.

Regent Sayles asked whether Mr. Ridley had any concrete ideas with respect to the implementation of sharing knowledge. Mr. Ridley stressed the importance of the use of technology, including the Internet. Senior Vice President Kennedy added that all of the course material for the new Business Officers Institute will be available on line.

Regent Clark observed that the review of the internal audit function was important to the discharge of the Regents' fiduciary responsibilities. He was encouraged that the University had been able to assemble a distinguished group of auditors to perform an external review, which resulted in a favorable report.

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

4. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 1997-98**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Activities, 1997-98**, was submitted for discussion by the Committee on Audit.

University Auditor Reed noted that the annual report contains a detailed description of the year's audit activity.

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

The meeting adjourned at 1:00 p.m.

Attest:

Associate Secretary