The Regents of the University of California

COMMITTEE ON AUDIT
September 16, 1999

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

Members present: Regents Bagley, Moores, Nakashima, Parsky, Preuss, Sayles, Taylor, and Vining; Advisory member Kohn

In attendance: Regents Atkinson, O. Johnson, S. Johnson, Khachigian, Kozberg, Leach, Lee, Montoya, and Pannor, Regent-designate Miura, Faculty Representatives Coleman and Cowan, Secretary Trivette, General Counsel Holst, Assistant Treasurer Young, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, Gurtner, and Hopper, University Auditor Reed, Chancellors Bishop, Carnesale, Cicerone, Dynes, Greenwood, Orbach, and Vanderhoef, Laboratory Director Browne, and Recording Secretary Nietfeld

The meeting convened at 11:25 a.m. with Committee Chair Vining presiding.

1. **UPDATE ON REVIEW OF SYSTEMWIDE CASHIERING CONTROLS**

Vice President Broome recalled that today's presentation was the result of a report made to the Committee at the July meeting regarding discrepancies in cash at the San Francisco campus and concerns raised by Regents that such circumstances might exist at other locations throughout the system. The Regents requested that the administration perform a review of cashiering controls on a systemwide basis and provide an update on the status of the review at the September meeting. The review examined the cashiering operations at the campuses, medical centers, Department of Energy Laboratories, and the Office of the President, excluding the San Francisco campus, which is conducting its own extensive review. The University and laboratories have 35 depository bank accounts and an average monthly deposit volume in excess $400 million. Ms. Broome explained that, in conducting the review, the administration compared University policies with industry best practices to evaluate controls. In many cases, the University's practices and policies were more extensive and more thorough than the best practices in industry. The review process applied a consistent approach and process at each location. It identified 93 specific core cashiering controls as required by University policy. The review used a control self-assessment methodology, assisted by Deloitte & Touche. Focus groups of staff who performed the actual cashiering were used at each location. The results of these focus groups were validated by management and by internal audit. The process was very conservative in order to identify all the areas in which corrective action was required. Vice President Broome reported that to date 95 percent of the main cashiering volume and 49 percent of the sub-cashiering volume have been reviewed. A plan is in place to complete the remaining control reviews by year end.

In order to analyze the results of the review, the control standards were grouped into the following five categories, taking into consideration the degree of risk: bank account reconciliation, separation of duties, accountability for cash, physical security, and other secondary controls. Vice President Broome presented the results to date.

Bank Account Reconciliation

The control standards for bank account reconciliation look at whether monthly statements are reconciled accurately and timely and reviewed by management, and whether any differences are investigated. This is the key control area for the cashiering function. The review found that 82 percent of operations were in full compliance with every aspect of the controls. In the 18 percent of the operations that were not in full compliance, either corrective action has been taken, or a plan for corrective action will be required.

Separation of Cashier Duties

The controls standards cover the following: accounts opened by the Treasurer only, the cashier performs no other duties, and the independent verification of bank deposits. In this category, 56 percent of the operations were in full compliance with every aspect of the controls. Fifteen percent had a mitigating control in place, while 24 percent needed corrective action. In five percent of the operations, policies were out of date due to technological advances.

Accountability for Cash

In this category, which involves maintaining accountability throughout the cash process, surprise cash counts, and employee background checks, 65 percent of the operations were in full compliance. Seven percent had mitigating controls, and 27 percent required corrective action. One percent will require a policy update.

Physical Security

The control standards for physical security are the following: cash deposited daily, armed transportation services provided, alarm systems in place, and controlling safe combinations. In this category, 73 percent of the operations are in full compliance. Six percent had mitigating controls, and 18 percent required corrective action. Two percent will need a policy update.

Other Secondary Controls

In the category secondary controls, 74 percent were in complete compliance with control standards. Five percent had mitigating controls in place, and 16 percent required corrective action. Six percent will require a policy update.

In summary, Vice President Broome reported that, with respect to all University cashiering policies, 72 percent are in full compliance and 6 percent have mitigating controls in place. Four percent are obsolete, while 18 percent require corrective action.

The next steps are to complete the cashiering controls review and complete the implementation of control improvements.

At the conclusion of her presentation, Vice President Broome introduced Mr. Dan Sampson, Director of Controls for the Office of the President.

In response to a question from Regent Leach with regard to the role of the campus controllers in the implementation of the control policies, Vice President Broome explained that the controllers led the review and validated the results. They will follow through in putting corrective actions into place.

Regent Leach noted that while overall the report was a positive one, there are still 18 percent of the operations that require corrective actions. High-level University administrators are usually not trained in business and do not have controls as their highest priority. He encouraged the chancellors and laboratory directors to see that their controllers are provided with adequate resources and are encouraged to see that the proper controls and policies are followed.

In response to a question from Regent Lee regarding why all locations do not follow University policy, Vice President Broome noted that the University has volumes of policies pertaining to financial management. Constant education is required to make staff aware of these policies. When resources are cut, controls tend to lapse. It is the role of internal audit to ensure that the University's policies are being followed.

Regent-designate Kohn asked whether the review had uncovered any particular pattern with respect to the areas requiring corrective action. Director Sampson reported that the review caused people to be aware of new issues with respect to controls; for example, a department's lack of a safe. The review did not identify any significant patterns which require attention. Vice President Broome added that one significant factor is the lack of adequate resources. Regent Vining pointed out that a lapse in control usually results either from staffing levels or the lack of a separation of duties. Vice President Broome agreed that small departments do not have the staffing required to separate some functions; new ways of doing business will need to be identified.

Vice President Broome addressed the question raised by Regent Taylor at the July meeting concerning records retention and the unauthorized destruction of records. She reported that prior to the discovery of problems at the San Francisco campus, a systemwide committee had been appointed to study records retention issues. The committee will address the issue of how to monitor compliance with policy. The cashiering review did not identify any abuse of the records retention policy.

2. STATUS REPORT ON FINANCIAL CONTROLS INITIATIVE

Vice President Broome recalled that the financial controls initiative is a program designed to strengthen accountability, responsibility, and control at each campus and at the Office of the President. The program has two components: implement a structure to improve the control environment, and employ models to assess, monitor, and improve controls. The main component of the structure is the creation and implementation of the controller function. The controller reports directly to the Vice Chancellor for Business and Administration and has a dotted-line reporting relationship to the Vice President--Financial Management. The responsibility of the controller is to develop and implement a campuswide system of internal control. The controller is to establish, evaluate, and support the control environment while providing financial leadership focus for campus operations.

Management has developed a control self-assessment program to assess, monitor, and improve the control environment. In order to put the program into place, it was necessary to adopt a conceptual framework in order to have a consistent approach throughout the system. The program looks at strategies and operating objectives in order to understand risk and then initiates a series of processes to control risk at an acceptable level of exposure.
Vice President Broome reported that the campuses are at various stages of implementing the controls initiative. While all of the campuses have adopted the model, the Davis, Irvine, Los Angeles, San Diego, Santa Barbara, and Santa Cruz campuses and the Office of the President have begun to implement the model. The campuses have tailored the program to specific operations to meet their needs. There is broad participation by campus management in the program. The San Francisco campus has recently appointed a controller. The Division of Agriculture and Natural Resources has recently undergone a reorganization of the Division and has created the position of controller, for which a nationwide recruitment is under way. At the Berkeley and Riverside campuses, while the controller function is in place, these two campuses have focused on the implementation of new financial systems. These new systems are designed to strengthen the controls for processing financial transactions.

Systemwide initiatives have focused on training, monitoring, and communication. The Office of the President has developed a Business Officer Institute to train the 2,000 business officers throughout the system and to communicate the University's expectations for the stewardship of its resources. The core curriculum of the Institute includes such topics as financial management and budget, the University's control environment, and the administration of sponsored research. In addition, the campuses are being encouraged to develop their own programs tailored to specific campus operations. With respect to monitoring, a firm has been hired to review the University's disbursements to identify potential opportunities for vendor overpayments. Such overpayments usually result from departments not receiving the most favorable terms and conditions from the vendor.

With respect to communication, a collaborative document was developed by internal audit and financial management to clarify systemwide responsibilities for internal control. The document stresses that management is responsible for the design and the quality of the controls, while there is an audit responsibility to validate the accuracy and the completeness of the controls.

Committee Chair Vining pointed out that the role of the controller during the installation of new financial systems should be to facilitate that effort. He did not want the report to leave the impression that the Berkeley and Riverside campuses were behind schedule.

3. **UPDATE ON INVESTIGATION OF FINANCIAL DISCREPANCIES, SAN FRANCISCO CAMPUS**

University Auditor Reed reported that, with regard to the internal investigation, there are essentially no new developments. Continuing efforts to review University records and reconcile other related accounts has provided no new evidence of additional fraud loss. The University's investigation efforts have continued to focus only on University records. No access has been gained to any personal or business records that would confirm the estimated loss or lead to the recovery of any of the missing cash. There is no new information from other sources regarding the possible use of the missing funds. In addition, the business operated by the former cashier's family has ceased operations, disposed of its inventory and retail store assets, and filed for bankruptcy protection. As a result of these facts, there continue to be no known prospects for recovery from identifiable assets which may have been acquired with UCSF funds.

The investigation task force has been scaled back to UCSF employees only. They are principally working on the preparation of the voluminous records to be presented to UC's bonding company. Internal auditors are working with the Office of Risk Management at the Office of the President and the Office of the General Counsel in preparation of the claim. The first meeting with representatives of the insurer is scheduled for next week.

Vice Chancellor Barclay reported that over the past two months the campus has expended considerable time and effort in addressing and eliminating the control weaknesses in the central cashier's office that led to the embezzlement. Immediately following the July meeting, a high-level campus work group was appointed to manage the efforts to shore up the cashiering operation at UCSF. The work group created a plan of action to correct each of the internal control deficiencies identified during the investigation. In developing the plan, the work group worked closely with the University Auditor to assure that it addressed the internal control deficiencies that were brought to light by means of the investigation. The campus also retained a consultant who is an expert in cashiering operations, procedures, controls, and risk management. Phase I of the plan was a thorough review of the central cashier's office. The consultant's recommendations have been implemented to bring the office up to standard. These recommendations include dual custodianship of all deposits, daily reconciliation of cashiering tapes to bank deposit records, timely bank statement and general ledger reconciliations, adequate separation of duties of accounting and cashiering staff, improved physical security, controls over record destruction, and training in the use of proper operating procedures. These steps should prevent another cash embezzlement from taking place in the central cashier's office. Mr. Barclay reported that he had also augmented the budget of the campus' internal audit department to compensate for the hours lost due to the investigation in order to allow it to stay current with its audit plan.

This week the campus began the implementation of Phase II of the plan, the essence of which is a comprehensive review of the entire cash management system, including the campus' fifty sub-cashiering stations. This review will determine whether a different approach to the central cashiering office and its multiple cashiering stations would further improve controls and lower costs. Phase III of the project will begin in late October and will be led by the campus' new controller. Initially this phase will focus on disbursements, specifically on vendor payments, wire transfers, and payroll. This phase will also review the balance of the campus' financial control environment, and it will be accomplished using the control assessment tools developed by the Office of the President.

In response to a question from Regent Leach, University Auditor Reed recalled that the embezzlement had been uncovered as the result of a management letter comment from the University's external auditors, Deloitte & Touche. Investigations by the internal audit department resulted in the retention of a consultant to investigate the matter further. By May 1999 it was determined that an embezzlement had occurred. Regent Leach noted that this situation demonstrates the important role played by the audit function. The controllers and the business officers have the responsibility of seeing that the University's policies are in place and are being followed, while the auditors have the responsibility to ensure that the controls are effective.

4. AUTHORIZATION TO SEEK PROPOSALS FOR EXTERNAL AUDIT SERVICES

The President recommended that he be authorized to seek proposals from national independent accounting firms for conducting the annual examination of the financial statements of the University of California for a three-year period beginning with the fiscal year ending June 30, 2000.

Vice President Broome recalled that the firm of Deloitte & Touche LLP was initially engaged as The Regents' independent accounting firm for the year ended June 30, 1996. Deloitte & Touche is completing its fourth year as the independent accounting firm of The Regents and is under contract to provide audit services for the year ending June 30, 1999. Prior to engaging Deloitte & Touche LLP, the independent accounting firm of KPMG Peat Marwick LLP was engaged by The Regents for twelve years.

While ongoing retention of an independent accounting firm is beneficial for continuity reasons, it is also beneficial and prudent to provide for a competitive selection process to compare costs and assess the quality and scope of services available.

The Committee was informed that, during the four years that Deloitte & Touche has served as The Regents independent accounting firm, fees for the annual audit examination, including expenses, have been as follows:

June 30, 1996	$1,136,000
June 30, 1997	$1,215,000
June 30, 1998	$1,180,000 (excluding UCSF medical center)
June 30, 1999	$1,400,000

Deloitte & Touche has proposed a considerable fee increase for the June 30, 2000 annual audit examination.

Because it has been four years since a competitive selection process has been carried out, the administration believes it is an appropriate time to initiate such a process for the selection of an independent accounting firm for the three-year period beginning with the audit examination for the fiscal year ending June 30, 2000. Deloitte & Touche will be invited to submit a proposal to retain the University as a client.

Committee Chair Vining stressed that the recommendation pertains to the issue of cost, not to the performance of Deloitte & Touche.

Regent Taylor noted the considerable effort and resources that Deloitte & Touche had devoted to the University's audit and asked whether selection would depend entirely upon cost.

Regent Vining responded that the proposals would not be evaluated strictly according to cost. Deloitte & Touche has requested a fee increase of 64 percent. In the past, the firm has spent more than the allocated 24,000 hours on the University's audit.

Vice President Broome reported that an evaluation committee would be established to review the proposals. The quality of service is an important factor, especially in light of the fact that the University is not required to accept the lowest bid. She added that the University had also paid $10 million to Deloitte & Touche for consulting services over the past year. In response to a question from Regent Bagley, Ms. Broome noted that University policy does not require it to competitively bid for a consultant's services if that consultant is already retained by the University.

Regent Leach stressed that Deloitte & Touche had performed well for the University, in contrast to the prior auditors, whose fees were considerably higher.

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

The Committee went into Closed Session at 12:25 p.m.

. . . .

The meeting adjourned at 12:45 p.m.

Attest:

Secretary