

The Regents of the University of California

**COMMITTEE ON AUDIT**

January 18, 2001

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

Members present: Regents Connerly, Davies, S. Johnson, Kohn, and Lee

In attendance: Regents Atkinson, Fong, Hopkinson, O. Johnson, Khachigian, Kozberg, Marcus, Miura, and Preuss, Regents-designate T. Davis, Morrison, and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Provost King, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome, Drake, and Gurtner, University Auditor Reed, Chancellors Berdahl, Cicerone, Dynes, Orbach, Tomlinson-Keasey, and Vanderhoef, Laboratory Director Browne, and Recording Secretary Nietfeld

The meeting convened at 8:55 a.m. with Committee Chair Connerly presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of November 16, 2000 were approved.

2. **MANAGEMENT LETTER OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2000**

The Management Letter of External Auditors for the Year Ended June 30, 2000 was submitted for discussion.

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

Vice President Broome recalled that the primary 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. She noted that, in addition to the management letter, the Regents had received a chart which summarized the auditors' recommendations and responses by management.

Mr. Robert Forrester, senior engagement partner for PricewaterhouseCoopers (PWC), introduced the management letter. He noted that management has the primary responsibility for reasonably ensuring that the mission and the objectives of the University are met.

### **University Initiatives for the Assessment and Management of Control Risk**

The University has undertaken a number of initiatives in the course of establishing a broader control structure. The internal audit program is the most established of these initiatives. The external auditors rely on the work of the internal audit departments and believe that the program continues to be strong. No specific recommendations have been made with respect to internal audit. Representatives of PWC have participated in a peer-review team, and the results of this review will be provided to the Regents by University Auditor Reed at a future meeting.

Mr. Forrester recalled that Vice President Broome had implemented a controls initiative which is active at the campuses and, to some extent, at the medical centers through their campus controllers. Each Department of Energy (DOE) laboratory will have a similar program, but it will not be a part of the official initiative. The recommendation has been made that these programs be analyzed to ensure that they are consistent with the objectives of the control initiative. Comments have been made to the chancellor of each campus on the status of the control initiative.

Mr. Forrester reported that Vice President Gurtner had established the health sciences clinical enterprise corporate compliance program. The external auditors relied to some extent on this program during their audit of third-party receivables. Each of the programs described is making good progress. In addition, former Senior Vice President Kennedy has undertaken an assessment of the feasibility of a systemwide research compliance program.

In the last year, the Office of the President has worked to identify software that could support the risk-assessment initiative established by the Vice President–Financial Management. The auditors have recommended that this software categorize the risks at the University and the controls that are available to mitigate those risks. They have also recommended that the University Auditor and the Vice President–Financial Management update their definition of risk and their respective roles in the process of assessing risk. The recommendation has been made that the Office of the President designate a systemwide compliance officer and that there be a report to the Regents on the status of both this program and the research compliance program.

### **Audit Coverage at the Department of Energy Laboratories**

Mr. Forrester recalled that at the March meeting the Regents had asked about the overall audit coverage at the three national laboratories. In response, PWC reviewed the audit coverage at each of the laboratories. The Office of Inspector General (OIG) and its contract auditors, KPMG, audit the financial statements of the Department of Energy. As a result, the auditors customarily focus on major accounts and cycle their work on these accounts among the laboratories. The work of the contract auditor is completed as of September 30, which is the end of the federal fiscal year. Consequently, there is no attestation as of June 30, the date of the University's financial statements,

of the laboratory accounts that are included in the consolidated financial statements of the University. In conformance with the University's contract with the DOE, each of the laboratories submits annual performance metrics for validation by the Office of the President. Through the annual internal audit plan and in some cases the work of KPMG, there is significant audit coverage of the internal control systems. PWC has recommended that The Regents, through the Office of the President and PWC, participate in the annual meetings that determine the audit coverage at the laboratories to ensure that the interests of the University are represented. A further recommendation is that the Office of the President assess the control self-assessment and research compliance programs to assure that they are meeting the objectives set forth for the controls initiative and the emerging research compliance program.

### **Information Technology Controls**

Mr. Forrester commented that the campuses, medical centers, and laboratories develop, implement, and monitor procedures and guidelines for their employees in order to implement the policy of the Office of the President on computer change management. The auditors have recommended that the campuses and medical centers implement standard, formalized change management procedures for all significant applications at each site. Further, the campuses should accelerate their efforts to develop and test business continuity and disaster recovery plans. A third recommendation is that the Office of the President provide policy guidance on security matters to be formally issued and communicated to all employees.

### **Medical Centers**

Mr. Gary Garbrecht, medical center partner, recalled that, as presented at the November meeting, there is a reportable condition at the UCSF Medical Center relative to the internal control structure. Management agrees with this observation and has put together an action plan to address the deficiencies. Detailed analysis and recommendations are contained in the management letter.

Mr. Garbrecht addressed the sustainable support from the medical centers to other elements of the University's health care system. He recalled that the University, with the auditors' concurrence, had adopted for fiscal year 2000 more explicit guidelines for allocating flows of net assets between the expense and transfer captions on the operating statements of the five medical centers. Vice President Broome presented preliminary results in September which showed that in the aggregate the medical centers had an excess of revenues over expenses of \$68 million, and from this and prior reserves they transferred \$139 million of support to other areas of the health system. At the Irvine, Los Angeles, and San Francisco Medical Centers, the transfer to support the health system exceeded the net income. This situation led PWC to question whether the medical centers should be expected to provide this level of support on a sustainable basis. PWC believes that the medical center campuses, the Office of the President, and The Regents would benefit from guidelines in this

area. These guidelines could be systemwide or specific to the location. Vice Presidents Broome and Gurtner will take the lead in this area.

Regent Connerly asked whether the auditors were comfortable that the medical centers were addressing the issue. While a great deal of discussion has taken place, Mr. Garbrecht emphasized that the issue is complex. Everyone has been receptive to the need for the implementation of guidelines. The matter has arisen at this time because the financial environment for the provision of health care has become so difficult.

Regent Lee asked whether the issue related to cash flow or to controls. Mr. Garbrecht noted that the control aspects would be addressed through the implementation of guidelines. The difficulty is in generating sufficient cash revenues to support the teaching hospitals.

In response to a further question from Regent Lee, Mr. Forrester reported that the auditors had met with the medical directors and dean. He suggested the need for a deadline in framing a response.

Vice President Broome continued that the administration is aware of the situation. It will be working with PWC to assess how other university medical centers are addressing the problem, given the difficult economic times that they face. Regent Marcus stressed the need for the administration to keep the Regents up to date.

Vice President Broome noted that the guidelines which are developed will need to be sufficiently flexible to take into consideration the business needs of both the medical centers and the teaching hospitals.

In response to a question from Regent O. Johnson, Mr. Forrester pointed out that the reportable condition was limited to the UCSF Medical Center. He continued that there was recognition by management at the Los Angeles campus of the issue of advancing funds for the medical center to support the mission of other elements in the health system. The auditors have recommended that the various medical centers draft formal agreements for the treatment of future funding arrangements.

Vice President Gurtner believed that the San Francisco medical center had developed plans to address the problems identified by the external auditors. The bigger problem which the medical centers face involves the transfer of funds to support the mission of the teaching hospitals. These revenues have always been used to support the medical schools. However, the traditional revenue streams that have supported the hospitals are declining. When \$50 million was allotted by the State for medical education five years ago, this forestalled the problems that the system now faces. The challenge that the University faces is not simply to define its mission of research, teaching, and clinical services but to determine how best to support them. In doing so, all of the sources of

revenue must be considered in recognition of the fact that the basic mission of funding the schools of medicine can no longer be done in the traditional way. The question facing the medical schools is how to replace the revenue stream that is being lost. It will be critical for the Regents to consider how the University should support its missions in the future. Without their responsibility for the medical schools, the University's hospitals would be profitable. The deans and directors understand and are struggling with this problem. Vice President Gurtner was hopeful that he would be able to present the Regents with some rational conclusions. The administration will look to the Regents for assistance in identifying new sources of funding.

Vice President Broome added that, in developing the guidelines, the University will need to be mindful of the medical centers' debts. Mr. Gurtner noted that, looking forward, there will be a substantial capital need that the Regents will also need to consider.

Chairman Johnson recalled discussion between some Regents and Congressman Thomas in Washington, D.C. about the future funding of graduate medical education. This problem must be revisited at the national level, with a restructuring of graduate medical support.

Vice President Gurtner observed that the way in which the University manages and funds its medical schools will change. Because of the pressures of managed health care in California, the University of California could define the future of medical education.

In response to the request from Regent Marcus that the Regents be kept up to date, Mr. Gurtner stated his intention to report to the Committee on Health Services on an ongoing basis on how the medical centers are responding to the issue of the level of support provided to the schools of medicine and the development of appropriate guidelines

Returning to the management letter, Mr. Garbrecht reported that the Los Angeles campus had advanced funds from its medical center to Physician Support Services without any formal agreements with respect to the treatment of the funds. The auditors have recommended that the Office of the President work with the management of the medical centers to draft formal agreements for the treatment of future funding arrangements, and this issue has already been resolved.

Mr. Garbrecht then discussed the implications of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), which addresses privacy, security, and administrative simplification for health care information that will be mandated for all health activities in the United States. At the time of the audit the campuses and the medical centers were beginning an assessment of how these regulations would affect them. Organizations have two years to bring themselves into compliance with the regulations. The auditors have recommended that each affected unit should begin a formal assessment of progress towards readiness for the HIPAA provisions.

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The meeting adjourned at 9:30 a.m.

Attest:

Secretary