The Regents of the University of California

COMMITTEE ON AUDIT
March 13, 2002

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

Members present: Regents Connerly, Davies, Lee, Marcus, Moores, Morrison, and Sayles

In attendance: Regents Atkinson, Blum, T. Davis. Hopkinson, Kozberg, Lozano, Montoya, and Pattiz, Regents-designate Ligot-Gordon and Terrazas, Faculty Representatives Binion and Viswanathan, Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, Provost King, Senior Vice President Mullinix, Vice President Broome, University Auditor Reed, Chancellors Cicerone and Vanderhoef, Acting Chancellor Warren, Auditor Reed, and Recording Secretary Bryan

The meeting convened at 10:20 a.m. with Committee Chair Connerly presiding.

1. **APPROVAL OF MINUTES**

Upon motion duly made and seconded, the minutes of the meeting of November 15, 2001 were approved.

2. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2002**

The President recommended that the annual audit plan for the year ending June 30, 2002 be approved.

The Committee was informed that the annual external audit plan of The Regents' auditor provides for a financial audit of the University of California, including the national laboratories and the University of California Retirement System. Additional audit coverage by the external auditor includes the National Collegiate Athletic Association (NCAA) audits, the revenue bond indenture audits, audits of the five individual medical centers, and the federal grants and contracts (A-133) audits.

At the November 1999 meeting, The Regents approved the appointment of PricewaterhouseCoopers LLP as external auditor for the three-year period beginning with the fiscal year ending June 30, 2000. Based on the Board's November 1999 acceptance of the PricewaterhouseCoopers LLP proposal, the total cost of the audit for the fiscal year ending June 30, 2002 is $2,140,700, which includes out-of-pocket expenses of $199,100. The FY 2002 fee includes $153,000 related to an increase in the scope of work and audit-related items not included in the original proposal, primarily as a result of the implementation of the new Governmental Accounting Standards Board financial reporting standards.

The ratio of consulting services to audit and audit-related services for the current and past two years is not significant. The University does not receive a substantial amount of consulting services from its external accountant which are not related to audit.

As discussed in the audit plan, PricewaterhouseCoopers LLP plans to spin off its consulting practice, which is responsible for providing the type of non-audit services that have been the focus of the Securities and Exchange Commission's and other agencies' investigations. The types of services being challenged as a potential impairment to auditor independence, primarily technology implementation and internal audit management, have not been provided to the University by PricewaterhouseCoopers LLP.

Mr. Mike Schini, the Engagement Partner, presented the scope of this year's examination and discussed developments in the accounting profession. He introduced Mr. Marv Shultz, a partner in the Los Angeles office and Mr. Rick Wentzel, a senior manager in the Los Angeles office, who have responsibilities related to the campuses in the southern part of the state.

Mr. Schini commented that completing an audit of the University is a vast undertaking in terms of the number and hours and of the diversity of the campuses and medical centers. He went through the audit plan briefly, highlighting specific items. He recalled that this year the University will be undergoing some significant fundamental changes in the way in which its financial statements are presented. The University and its external auditors have been working for nearly two years to develop new systems dealing with auditing and accounting issues. He noted that the financial statements will look different this year. A second item of emphasis in the overall audit will be assessing risk related to contracts and grants. There are significant and complex compliance requirements related to the administration of federal grants and contracts, as well as State monies, that come to the University. Thus, the revenues and financial reports pertaining to the University's medical centers, which receive substantial federal funds, are a particular focus of the auditors.

Mr. Schini noted that from the balance sheet standpoint, the largest risk area is the investment portfolio. Seventy percent of the University's assets are investments. The audit approach includes the use of a specialized team of professionals who are knowledgeable about investments and investment issues.

Mr. Schini reported that this year there are new independent standards required by the General Accounting Office. They add requirements related to documentation and the types of services that the auditors may provide. The accounting profession has come under scrutiny since the demise of the Enron Corporation. Numerous organizations are examining the types of service provided by accountants and their standards. While awaiting the outcome of these investigations, PricewaterhouseCoopers has made commitments to eliminate any future questions by the public regarding integrity issues within the accounting profession.

Regent Lee asked how often Regents get involved in discussions with the auditors. Mr. Schini responded that there are private sessions with the Chair of the Committee. He assured Regent Lee that, while there are limits on what may be discussed, any indication of a problem is reported to the Committee Chair directly.

Regent-designate Terrazas noted that the auditor plans to add three outside, independent directors to its global board. He asked whether any of them will have expertise related to public institutions. Mr. Schini believed that the prospective directors are people who have a knowledge of accounting but who do not work in the accounting profession. He believed that they would likely be people with a public background.

Regent Morrison asked whether in the course of the audit the auditors obtain from the General Counsel an opinion as to potential contingent liabilities, as is done in private companies. Mr. Schini responded that there is a materiality standard of about $5 million. The General Counsel forms a conclusion as to whether there are any material items that should be approved.

Regent Lozano noted that institutions like the University are being expected to exercise more oversight in view of the Enron case. She asked about any plans for the Audit Committee to meet more often. Committee Chair Connerly did not foresee any acceleration of the meeting schedule within the next four months. Regent Lozano advocated assessing whether the amount of time the Regents spend with the auditors reviewing the University's financial performance is sufficient.

Mr. Schini recalled that the Regents had received a mailing from the auditors that contained a comparison of Enron's issues to those of the University. Nine accounting issues relating to Enron's financial statements and reporting caused a lack of visibility about Enron's financial position. Half of these issues are not applicable to the University. Of the half that are applicable, he noted that Enron was a leveraged entity with a 5-to-1 ratio of assets to net assets. The University is not a leveraged entity. It has debt, but its ratio of assets to net assets is 1.2. Enron also used many special-purpose entities and limited partnerships, arrangements which have not been used by the University. Part of the reason for the rapid decline in Enron's performance was the drop off in the energy market and the fact that many of their derivative transactions needed to be marked to the market. The University does not enter into high-end derivatives, but its investment portfolio must be carried at market. Declines in the market value will affect the University's bottom line. The investment portfolio is highly diversified; nevertheless, if the market declines, the University's bottom line is affected dollar for dollar. The Enron auditors had identified waived adjustments which were not deemed to be material. For the earliest year, those were 50 percent of net income; they were not significant in later years. Mr. Schini noted that PricewaterhouseCoopers identifies waived adjustments as part of its audit and reports them. They are in the range of 1 percent. Enron had debt liquidity accelerators that are not in place at the University. Its employees had significant portions of their net worth in Enron stock. There is no University of California stock; however, retirees do have a significant portion of their net wealth managed by The Regents. Related-party transactions do not exist at the University, although there are related-party transactions with entities such as the foundations which are not consolidated in the financial statements, and there are many transactions with the State. The issuance of debt done through State entities is disclosed. The University also has commitments and contingencies that are disclosed. In summary, the University is not comparable to Enron. Although there are some common accounting issues, these are common for many companies.

Regent Sayles asked about the areas where the auditor provides consulting services to the University in addition to auditing services. Mr. Schini responded that the auditors provide consulting if there are matters to be addressed concerning implementation of the new Governmental Accounting Standards Board standards. It provides services to the hospitals on issues concerning structure and the development of pricing strategies and to the Los Alamos laboratory on questions concerning organizational structure. Regent Sayles suggested that those consulting arrangements should be examined to ensure that they do not create the appearance of a conflict of interest for the University. Vice President Broome noted that the ratio of consulting services to the core audit is extremely low.

Regent Marcus noted that it is customary to rotate auditors. Ms. Broome reported that the University conducts bids for its auditing services every three years. This schedule provides sufficient time for the auditors to become familiar with the workings of the University.

President Atkinson asked how the role of judging and evaluating the adequacy of the University's internal audit process is handled. Mr. Schini explained that the auditors obtain an understanding of how the internal audit departments are organized and how their members are trained. It is a check to ensure that the internal auditors have the appropriate backgrounds and are using the appropriate scope. The Regents would be alerted if any problems in internal audit were discovered.

Committee Chair Connerly asked whether the Regents' oversight function should be changed. Mr. Schini believed that the idea of meeting more frequently should be considered. He noted that because the University does not report on a quarterly basis, the Committee holds fewer meetings than a public company. Committee Chair Connerly suggested the possibility of forming a subcommittee to meet between regularly scheduled Regents meetings. These meetings would have to be held within the structure of the laws governing public meetings. Regent Davies suggested that questions concerning the frequency of Committee meetings and the style in which they should be held should be referred to the Special Committee on Regents' Procedures.

The meeting adjourned at 10:50 a.m.

Attest:

Associate Secretary