The Regents of the University of California

**COMMITTEE ON AUDIT**
November 13, 2002

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

Members present: Regents Connerly, Lee, Lozano, Moores, Parsky, and Terrazas

In attendance: Regent Montoya, Faculty Representative Pitts, Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, Senior Vice President Mullinix, Vice President Broome, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 3:12 p.m. with Committee Chair Terrazas presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of September 19, 2002 were approved.

Regent Terrazas reported that, based upon the Committee's discussion at its September 19 meeting and with the assistance of Regent Hopkinson, a Request for Proposals had been issued for an external review of the internal audit program. The intention is for a report to be presented to the Committee at its March meeting. Senior Vice President Mullinix stated that he would screen the applications and make a recommendation to Chairman Moores and Committee Chair Terrazas.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2001-02**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Activities, 2001-02**, was submitted for discussion.

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

University Auditor Reed presented an overview of the annual report. He began with a chart which compared the planned number of hours and the actual number of hours that were devoted to the various audit activities, noting that 114,000 hours were spent conducting audits, which exceeded the plan by 12,000 hours and the prior year by 9,000 hours. Internal Audit issued 297 audit reports, compared with 309 in 2000-01. The average number of hours spent on a project this year was 358, which was well in excess of the plan. Turning to the category of advisory services, Mr. Reed reported that Internal Audit had nearly achieved the plan goal of 35,836 hours. The staff completed 195 projects, which was an increase of 43 percent over the prior year. He stressed that advisory service projects require significantly less time than do audits. Investigations continue to show a decline in hours, with the 17,817 hours devoted to this category less than the plan and the prior year. The number of significant crimes that merited reporting to the Office of the President declined from 88 to 56. Mr. Reed noted that the decline in the average number of projects per auditor could be attributed to newer staff. The 73 percent completion of the plan reflects a dynamic audit environment; the industry benchmark is 70 percent. University Auditor Reed presented the distribution of effort by service type, observing that audits, at 69 percent, is still the foremost activity of the Internal Audit department.

Turning to Internal Audit staffing issues, Mr. Reed reported an increase of 10 auditors over the previous year, resulting in 93 percent of the positions being filled. The turnover rate declined and was less than the industry average. These facts reflect the effect of the downturn in the economy, with people less likely to move on to new positions and a wider pool for recruitment. He presented charts which displayed the ratio of expenditures to auditors for the campuses and the Office of the President. While there are differences by location, with smaller campuses tending to have more favorable ratios, all the locations appear to be reasonably well staffed in relation to the norm.

University Auditor Reed presented the following conclusions to the annual report:

- The University's internal control environment is judged to be reasonably effective.
- Management is cognizant of its responsibilities for controls and accountability.
- Management works collaboratively with Internal Audit to identify and address risks and audit recommendations.
- The Internal Audit program is respected, cooperation is received, and there is no interference in its duty to The Regents.
- Matters of importance are reported to The Regents.
- The Internal Audit Program has continued to invest in continuous improvements through the strategic plan.

Mr. Reed advised caution in the current fiscal climate due to factors that could bring pressure upon the control environment if there is a reduction in training or staff. He recalled that in the early 1990s there had been a great loss of institutional memory due to early retirement programs. He stressed that a number of initiatives designed to strengthen the internal controls had been implemented since that time.

Regent Lee recalled that the University was now required by the Governmental Accounting Standards Board to depreciate its assets, and he asked how that had been achieved. University Auditor Reed explained that the deprecation was a bookkeeping function that did not affect the University's cash position. The purpose of depreciation is to spread the cost over the useful life of the asset. The new methodology was developed by campus and Office of the President staff, and the systems used to calculate depreciation were reviewed by Internal Audit.

In response to a further question by Regent Lee, Vice President Broome explained that the University maintains an inventory of its assets, regardless of value. Over the past three years, all of the University's assets were inventoried and then entered into a database. Coordination was required with the medical centers, as they had had the practice of depreciating their assets.

Faculty Representative Pitts asked how Internal Audit would cope with diminished resources when developing its audit plan, particularly in light of the cautionary remarks that the University Auditor had presented. Mr. Reed expressed the hope that the ability to perform audits would not be diminished by the need for more investigations. With respect to the audit plan, he explained that it is based upon a risk analysis. There are certain core functions of the University that are audited on a three-year cycle, such as construction, accounts payable, and financial aid. To leverage Internal Audit's resources, the staff performs truncated audits of chosen academic departments in order to ensure that basic functions are being carried out properly and to achieve an audit presence on campus.

Regent Lozano asked for comment on the process involved in reporting a suspected improper act to the Office of the President. Mr. Reed explained that the campus advises the Senior Vice President and the University Auditor at the outset of the investigation. He reviews the draft report to make sure that it addresses the issues raised and that management's action plan is sufficient. Management reports the conclusion of the matter to Senior Vice President Mullinix to communicate both the audit findings and the corrective action that was taken. The Office of the General Counsel is advised if criminal acts should be reported to the police, and the UC police are the conduit to the District Attorney.

Committee Chair Terrazas suggested that it would be helpful for the Committee to meet with the University Auditor in a Regents Only session similar to the one that is held annually with The Regents' external auditors.

3. **ANNUAL REPORT OF THE EXTERNAL AUDITORS FOR THE FISCAL YEAR ENDED JUNE 30, 2002**

In accordance with the Schedule of Reports, **the Annual Report of the External Auditors for the Fiscal Year Ended June 30, 2002** was submitted for discussion.

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

It was recalled that the objective of The Regents' external auditors in performing the basic University audit is to render an opinion on the 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 annual report consists of PricewaterhouseCoopers' Report to The Regents (the management letter) and its Required Communications to the Board of Regents.

Vice President Broome introduced the audit team from PricewaterhouseCoopers: Mr. Mike Schini, the engagement partner; Mr. Gary Garbrecht, the medical center partner; and Mr. Rick Wentzel, the senior manager for the audit. Mr. Schini recalled that, as discussed by the Committee on Finance at today's meeting, the University had implemented a series of significant changes in its accounting systems as a result of new accounting standards required by the Governmental Accounting Standards Board (GASB). He complimented the administration on the successful implementation of the new standards. Mr. Schini presented remarks highlighting the Required Communications, which discuss in some detail the changes that the University was required to make in its financial statements as a result of the new GASB standards. He reported that PwC had reviewed the process that the University uses in developing accounting estimate and believes that the process is reasonable. Any estimates, however, may differ materially from actual results. Some of the more significant estimates inherent in the financial statements, together with their related amounts at June 30, 2002, include the following:

- Self-insurance reserves: $453 million
- Reserves for bad debts: $278 million
- Reserves for medical center third-party payor settlement liabilities: $140 million
- Carrying values of certain private investments: $908 million.

Mr. Garbrecht addressed the issues posed by the medical centers' third-party payor settlement liabilities. He reported that each medical center has contracts with Medi-Cal and Medicare programs for reimbursement of health care services. Each hospital in the state is required to submit an annual statement of reimbursable costs, which are subject to an outside audit. Because of this outside audit and the fact that the rules are subject to interpretation, Mr. Garbrecht believed that the $140 million reserve had a higher degree of uncertainty than a normal estimate would.

Mr. Schini concluded by reporting that there had been no instances of disagreement with management during the course of the audit.

In response to a question from Regent Lee regarding lawsuits, Mr. Schini explained that PwC receives a letter from the General Counsel which describes any litigation brought against the University and the determination of any material effects of such litigation on the financial statements. There is a disclosure in the financial statements that states that the University is from time to time involved in matters of litigation that it believes would not have an effect on the financial position. Senior Vice President Mullinix continued that the University's losses due to litigation are covered by its self-insurance program.

Regent Lee asked about the estimated carrying value for certain private investments. Mr. Schini explained that this relates to investments in private equity, specifically in venture capital funds that have no published value. Regent Parsky asked to what extent the external auditors had looked at the entire Regents' portfolio in order to estimate the $908 million carrying value. Mr. Schini explained that the estimate was based solely upon the venture capital portion of the portfolio; it did not include buyouts.

Regent Lozano urged the administration to be watchful with respect to the medical centers' potential settlement liabilities.

Turning to the management letter, Mr. Wentzel recalled that PricewaterhouseCoopers, as part of the external audit process, issues letters to each chancellor and Department of Energy laboratory director; in the current year, 31 comments were issued. The management letter contains common themes across the campuses and represents the most pervasive comments that appeared at the various locations. The report details each of the comments as well as management's response. The first comment, which is applicable Universitywide, discusses GASB Statement No. 39, "Determining Whether Certain Organizations Are Component Units and Amendment of GASB Statement No. 14." For the 2003-04 fiscal year, the University will be required to include the ten campus foundations in its financial statements. PwC has recommended to the Office of the President that, in implementing GASB Statement No. 39, it build upon the experiences gained over the past three years.

Mr. Garbrecht commented on the shifting regulatory environment for the medical centers, noting that PwC had recommended to the medical centers that they review and ensure continued focus on the implications of both new and existing regulations and continue or enhance compliance with them. A second area of focus is the Health Insurance Portability and Accountability Act (HIPPA), which was enacted in 1996 to assure health insurance portability, reduce health care fraud and abuse, guarantee privacy, and enforce standards for health information. As in the prior year, PwC has recommended that the medical centers continue with their efforts to comply with HIPPA. Effective next fall, the forms required to admit a patient will be replaced with forms that are dictated by HIPPA. This change could represent a significant challenge for most hospitals. University Auditor Reed commented that a systemwide task force had been charged with training personnel to comply with HIPPA. It is also analyzing how HIPPA would affect all of the University, including the national laboratories, student health centers, and athletic programs.

Regent Lee referred to the Internal Control Report to The Regents which is provided in the management letter. Mr. Schini explained that the report covers only those matters which were communicated at the level of the chancellor and are common across the campuses. Regent Lee observed that some responses were still open. Vice President Broome reported that her office requests a status report every six months. Regent Lee believed that the Committee should be informed about which issues had been resolved and which were still outstanding in order to increase the level of involvement of the Committee. Vice President Broome pointed out that the management letter reports on management's response for each campus. Regent Lee believed that a brief comment in the management letter on ongoing matters would be sufficient, and Mr. Schini agreed to expand the in-process section in next year's report.

In response to a question from Regent Connerly, Mr. Schini stated that any important issues had been communicated to the chancellors. The campuses' response to internal controls has been positive.

4. **APPROVAL OF REGENTS' EXTERNAL AUDIT CONTRACT**

The President recommended that The Regents' contract with the current external auditor, PricewaterhouseCoopers (PwC), be extended for an additional three-year period.

Vice President Broome recalled that at the November 1999 meeting, after a formal bid and proposal process, PwC was appointed as The Regents' external auditor for a three-year period beginning with the 1999-2000 fiscal year. The expectation during the bid and proposal process was that the firm selected would be retained for a multi-year period.

At the September 19, 2002 meeting of the Committee, the members reviewed a process for evaluating the existing service arrangements with PwC and the negotiation of an extension of the existing contract if such evaluation determined that retention of PwC was in the best interest of the University. University management has evaluated the quality and delivery of PwC's services in the following areas:

- Expertise:
    - Higher Education
    - Health Care
    - Retirement and Employee Benefit Plans
    - Investments
    - Federal Programs
- Industry Leadership
- Access to Firm Specialists
- Staff Quality and Continuity
- EDP Audit Approach
- Coordination with Management

Evaluations were received from business and financial management at the campuses, medical centers, national laboratories, and Office of the President. The evaluations indicated a significantly high level of satisfaction at all locations with both the quality and delivery of the external audit services provided by PwC. Additionally, management felt that significant costs would result from another change in external audit services.

Vice President Broome reported that, based on the results of the evaluation, her office had negotiated a continuation of the existing contract for a term of three years. The terms of the contract are identical to The Regents' existing contract and provide for annual cost increases of 6 percent over the three-year period. Audit fees, as a result of any future changes in the scope of work, will be adjusted as appropriate.

Committee Chair Terrazas asked why the auditors had proposed a cost increase, given their greater familiarity with the institution. Senior Vice President Mullinix pointed out that the external audit universe had changed dramatically in the past year, with resultant cost increases. Vice President Broome added that PwC charges the University a lower rate than it does its private clients.

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 4:10 p.m.

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The meeting adjourned at 4:45 p.m.

Attest:

Associate Secretary