

The Regents of the University of California

COMMITTEE ON AUDIT

September 17, 2003

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

Members present: Regents Bodine, Connerly, Davies, Hopkinson, Lee, Lozano, Moores, and Pattiz; Advisory member Pitts

In attendance: Regents Atkinson, Huerta, and Preuss, Regents-designate Novack and Ornellas, Secretary Trivette, General Counsel Holst, Treasurer Russ, Senior Vice President Mullinix, Vice President Broome, Chancellor Dynes, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 4:00 p.m. with Committee Chair Connerly presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of May 14, 2003 were approved.

2. **EXTERNAL AUDIT UPDATE**

Mr. Mike Schini of PricewaterhouseCoopers, The Regents' external auditors, commented that PwC had no significant financial reporting issues to discuss with the Committee. He recalled that, due to government regulations, the campus foundations will be included in the University's 2004 financial statements as a discretely presented unit. As reported at earlier meetings of the Committee, PwC performed an expanded scope audit of the national laboratories and, as a result, there will be comments in the Management Letter related to Department of Energy reporting. The assets of the laboratories are owned by the DOE, and separate financial statements are produced for them. The University reports the revenues and expenditures related to the laboratories. Reconciliation issues primarily affect the reporting of the DOE.

3. **INTERNAL AUDIT UPDATE**

University Auditor Reed asked if the Committee members had any questions or comments with respect to the report for the quarter ending June 30 which had been mailed on September 5. Regent Hopkinson noted that a considerable amount of attention is being paid to the national laboratories and asked how that was affecting work at the campuses. Mr. Reed recalled that, beginning in January 2003, a large number of Los Alamos National Laboratory staff had been incorporated into the internal audit program. Very few staff from the campuses and laboratories have been sent to perform audit work at Los Alamos. He believed that progress was being made there; the recruitment process for the new audit director is well under way. He anticipated that permanent leadership would be in place by

November 1. Over the summer attention has been devoted to catching up on backlogs of work, re-engineering processes, and rehabilitating relationships with the Department of Energy, senior management, and the Office of the President.

4. **INTERNAL AUDIT RECOMMENDATIONS AND CHANGES IMPLEMENTED**

University Auditor Reed recalled that at the Committee's request, in early 2003 the consulting firm Protiviti performed a review of the University's internal audit program and made several recommendations with respect to the following:

- Review the procedures, processes, and organizational structure that assure the independence of all the various elements that comprise the internal audit function; and
- Review the practices, policies, and procedures for reporting audit findings and conclusions in comparison to professional standards and best practices, again with a view toward assuring independence and objectivity.

Mr. Reed noted that a summary report on the implementation of the Protiviti recommendations had been distributed to the Committee. One recommendation focused on strengthening the internal audit program and in particular its reporting relationships. In order to enhance independence, the dual reporting guidelines will be amended to indicate further responsibilities of the University Auditor. Mr. Reed added that the University had essentially accepted all of the recommendations made by Protiviti.

Regent Hopkinson pointed out that Protiviti had recommended that certain sensitive investigations be performed by the University Auditor or an outside consultant if independence of the campus or laboratory auditor could be impaired. The response of internal audit indicates that it has long provided guidance for referral of matters to the University Auditor's Office if a local conflict of interest is present. It was her belief that more than guidance would be required. University Auditor Reed assured her that such referral is seen as a requirement in the systemwide audit manual. He agreed to share the exact language in the manual with the Committee.

Regent Hopkinson raised the issue of internal audit policies that deal with such things as employee theft and malfeasance. University Auditor Reed explained that such actions are covered in the whistle blower and investigation policy, which incorporates State law in University policy and establishes the University policy for reporting and investigating any such allegations. Regent Hopkinson asked whether there are requirements that certain types of procedures be enacted when a crime is committed by an employee. Mr. Reed explained that the investigation policy sets forth how an investigation should be conducted, but it does not spell out the consequences that should result.

Regent Lozano suggested the need for a systemwide policy that would address the situation described by Regent Hopkinson. University Auditor Reed believed that the consequences that would result from a crime committed by an employee were personnel matters unrelated to internal audit. Senior Vice President Mullinix added that there are overall University policies that require disciplinary action for both faculty and staff. The implementation rules are usually specific to the campus.

Committee Chair Connerly asked whether it was the responsibility of internal audit to determine campus compliance with University policies. Mr. Reed confirmed that this was a fundamental part of internal audit's role. Mr. Mullinix noted that, as a result of concerns that had been expressed by the Committee, a number of audits had been conducted in human resources to assure compliance with policies on the campuses. Mr. Reed added that any wrongdoing that is found to be a criminal act is reported to the proper authorities.

In response to a question by Regent Lee, Mr. Reed explained that the internal audit department reviews contracts signed by the campuses on a selective basis. Mr. Mullinix commented that, in the case of the University, the internal audit scope is broader than purely financial issues. Regent Connerly observed that The Regents adopts an internal audit plan which outlines the areas of responsibility that will be audited over the course of the year.

In response to a question by Regent Hopkinson, University Auditor Reed explained that the reporting relationship of the laboratories is the same as for the campuses. The best practices as defined by the Institute of Internal Auditors indicate that auditors should report functionally to the Audit Committee and administratively to senior management. He recalled that the suggestion had been made that the campus and laboratory audit directors have a more direct relationship with the Committee. Regent Hopkinson was concerned that appropriate controls were in place at the national laboratories. Mr. Reed acknowledged the fact that this had not been the case, particularly at Los Alamos, but that these controls are now in place.

5. **AUDIT COMMITTEE RECOMMENDATIONS**

University Auditor Reed recalled that the Protiviti report had suggested amendments to the Committee's charter, as outlined in Bylaw 12.1. The amendment proposed by the Office of the President is as follows:

- A. The Committee on Audit shall advise the Board of Regents in connection with the Board's responsibilities relating to the quality and integrity of the University's financial reporting, compliance with legal and regulatory requirements, systems of internal control and risk mitigation, independent certified public accountant's qualifications and independence and the performance of internal audit and the independent certified public accountant.
- B. The committee shall meet at least four times a year.

C. The Committee shall:

- (1) Monitor the University's systems of internal control and the adequacy of accounting, financial, and operational policies and practices on financial and significant compliance reporting.
- (2) Review the annual internal audit plan and discuss the extent that it addresses high-risk areas with the University Auditor and management.
- (3) Review the annual report on accomplishments of the internal audit department and discuss significant issues of internal control and compliance with the University Auditor and management.
- (4) Discuss the planned scope of the annual audit and other engagements with the independent certified public accountant and review the results of the audit and other engagements with the independent certified public accountant and management.
- (5) Receive and review the annual financial report with the independent certified public accountant and management.
- (6) After considering the recommendations of management, recommend to the Board the certified public accountant to serve as independent auditor and pre-approve any services provided by the certified public accountant.
- (7) Have the power through its Chair, to call special meetings of the Committee and to request management to address specific issues within the mandate of the Committee and have the authority to engage independent counsel and other advisors to carry out its duties.

Mr. Reed noted that the intention was to provide for greater breadth and clarity as to the Committee's role as defined in Bylaw 12.1. The amendment will be presented for adoption at the November meeting.

6. **SARBANES-OXLEY ACT RECOMMENDATIONS**

University Auditor Reed explained that while the Sarbanes-Oxley Act, which was designed to address corporate fraud, does not apply specifically to a public institution such as the University of California, Protiviti had conducted a detailed review of its provisions and had suggested that certain reforms be adopted by The Regents. Several states have now introduced legislation that would make the law applicable to all not-for-profit organizations. Mr. Reed noted that the University's response to the Protiviti report with respect to Sarbanes-Oxley had been distributed to the Committee. The response also includes the perspective of higher education as represented by the National Association of

College and University Business Officers. Mr. Reed recalled that last September, following the passage of the Sarbanes-Oxley Act, The Regents had adopted standards for audit and non-audit services to be performed by The Regents' external auditors. While the University will comply with many elements of the legislation, the requirement that there be an independent attestation as to the accuracy of the financial statements would be expensive to implement.

Regent-designate Novack suggested that the University may wish to recruit a member of its alumni to serve as a financial expert on the Committee. Regent Davies reported that the Special Committee on Regents' Procedures intended to recommend a policy that would provide for advisory members on the Committee.

Mr. Novack observed that the internal audit report appears to be an activity report that does not address the contents of the auditors' work. He suggested that there should be some mechanism that would keep management abreast of financial activity. University Auditor Reed noted that the internal audits tend not to focus on the University's financial statements. He agreed with Regent-designate Novack's assessment of the quarterly reports but pointed out that he tries to synthesize the work of the staff in the annual report. Vice President Broome added that, as an example, in general, although higher education institutions close their books once a year, the Regents are provided with quarterly activity reports for the hospitals.

Regent Lee believed that PricewaterhouseCoopers should be asked to comment on management's recommendations with respect to the implementation of provisions of the Sarbanes-Oxley Act. Mr. Schini reported that most of his clients were adopting certain elements of Sarbanes-Oxley that represent best practices. There is a white paper on the subject which he offered to share with the Committee.

In response to a comment by Regent Lozano, Senior Vice President Mullinix stated that management intended to implement the changes that had been discussed in response to the Protiviti report on Sarbanes-Oxley.

The Committee went into Closed Session at 4:45 p.m.

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The meeting adjourned at 5:40 p.m.

Attest:

Secretary