The Regents of the University of California

COMMITTEE ON AUDIT
July 14, 2004

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

Members present: Regents Blum, Connerly, Hopkinson, Lozano, Novack, and Parsky; Advisory member Pitts

In attendance: Regents Anderson, Dynes, Johnson, Marcus, Montoya, and Ornellas, Regents-designate Juline and Rominger, Faculty Representative Blumenthal, Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, Provost Greenwood, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome, Drake, and Hershman, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Córdova, Tomlinson-Keasey, Vanderhoef, and Yang, Acting Chancellor Chemers, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 8:30 a.m. with Committee Chair Novack presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of March 18, 2004 were approved.

2. **ANNUAL REPORT OF INTERNAL AUDIT PLAN, 2004-05**

In accordance with the Schedule of Reports, the **Annual Report of Internal Audit Plan, 2004-05**, 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 observed that the overall objective of the internal audit plan is to deploy resources effectively and efficiently in order to meet multiple objectives, which include the following:

- Providing an audit program that addresses contemporary risks while ensuring appropriate attention to core business functions and broad audit coverage of the University over time.

- Assuring that adequate audit attention is directed to unique campus, health science, national laboratory, and Office of the President activities.

- Having available sufficient resources to perform investigations as necessary without excessive intrusion on the audit program and being available for consultations, special projects, and other management assistance as appropriate.

A risk assessment process drives the preparation of the audit plan at each campus, medical center, and national laboratory, which includes an evaluation of each auditable unit of the University, of which there are thousands. These units include academic departments, organized research units, and auxiliary enterprises. The campuses submit their initial assesments to the Office of the University Auditor, where an overall analysis is performed to identify common themes and trends of risk. The campus audit plan is discussed by the campus audit committee and approved by the Chancellor. Mr. Reed explained that five predictive factors are used to perform the risk assessment. These include the quality and stability of the control environment, as change is a good predictor of risk. A second factor is business exposure, which includes the liquidity of the assets. The third factor is public and political sensitivity, while the fourth is compliance requirements. A final factor is information technology and management reporting. The plan represents an attempt to address contemporary risk and provide attention to core business functions, including payroll, accounts payable, and information technology controls. Core business functions are audited on a three-to-five-year rotating cycle.

The intention of the plan is to devote 62 percent of internal audit efforts to areas of perceived highest relative risk and 44 percent to defined core business activities. Because of the overlap between the two areas of activity, when combined they will consume 69 percent of the efforts, leaving 31 percent of the audit hours available for a program of broad audit coverage and supplemental and other services. The plan will commit resources among the University's operating lines of business as follows: campuses, 42 percent; health sciences, 23 percent; national laboratories, 31 percent; and Office of the President, 4 percent. These percentages are driven mainly by staffing levels. The percentage for the national laboratories is higher than in previous years because of staffing for additional functions at Los Alamos. University Auditor Reed continued that the plan will allocate 56 percent of available effort to a program of planned and specially requested audits, 18 percent to advisory services, 19 percent to investigations, and 7 percent to audit support activities. The plan also assumes that eight FTE positions will be filled.

University Auditor Reed highlighted a display which covered the areas identified as high risk. Each location will be involved in financial reporting, research compliance, and IT controls. Physician receivables and hospital receivables are audited at all of the medical centers. A high risk for the national laboratories is the area of cost allowability clauses; this is the most important audit that is performed each year at the laboratories and is mandated by the University's cooperative audit strategy agreement with the Department of Energy.

In response to a question from Regent Lee, University Auditor Reed stated that Internal Audit did not have the resources to audit security at the national laboratories. Personnel at the laboratories have the expertise to monitor security measures, and oversight is provided by the Office of the President.

Regent Hopkinson recalled that the Bylaw pertaining to the charter of the Committee on Audit had been amended recently to include the responsibility to monitor the adequacy of the accounting, financial, and operational policies and practices related to financial, accounting, and compliance and ethics reporting. In her review of the 500 projects identified for the 2004-05 internal audit plan, she found nothing that related to the issue of ethics.

University Auditor Reed acknowledged the need to develop a Universitywide ethics policy. There is a code of conduct that was approved by The Regents as part of the health sciences compliance program. Regent Hopkinson pointed out that the Committee has responsibility for issues such as sexual harassment, discrimination, and conflicts of interest; these topics cannot be covered in the course of a normal audit. Mr. Reed noted that conflict of interest audits pertaining to research had been performed on the campuses. Regent Hopkinson saw the need to focus on existing policies as a new program for ethics is developed, as well as a need to understand whether the University's policies were being complied with. She asked that Appendix 3 - Detail of Planned Projects - be modified to list specific projects pertaining to ethics and be brought back to the Committee.

Regent Lozano asked for a clarification of why public and political sensitivity are seen as good predictive factors for risk. University Auditor Reed explained the that risk assessment process involves a weighting of risk factors. The public and political sensitivity reflects Internal Audit's awareness that certain funds may be more sensitive than others; one example would be the increased funding provided for the University's outreach programs during the late 1990s. The predictive factors are used by the auditors to make the inherently subjective somewhat objective.

Regent Lozano asked whether University Auditor Reed wished to share any concerns he may have about the competence of audit personnel. Mr. Reed noted that the audit directors frequently discuss the need to assure that the right level of professional expertise is brought to every audit. The risk assessment process begins with the question of whether the auditors understand the area well enough to assess risk. Internal Audit has a skills assessment process that helps to determine the training that should be available to audit staff. There have been specialized training programs offered in a variety of audit areas, including construction and information technology, and outside consultants have been used when necessary to augment internal skills.

3. OVERVIEW OF THE UNIVERSITY'S INTERNAL CONTROL STRUCTURE AND ENVIRONMENT

Vice President Broome began her remarks by observing that internal control is a means to an end, not an end in itself. It is not only policy manuals and forms but people at every level of the organization. Internal control provides reasonable assurance, not absolute assurance, to management and to the Board. Ms. Broome noted that the University's comprehensive control structure includes the campuses, medical centers, and national laboratories. A common framework of internal control has been adopted in order to provide consistency throughout the organization. The University's internal control structure begins with the Board of Regents, which has responsibility for overall governance. The President and senior officers set the tone at the top with respect to the importance of a strong control environment. The selection of management is another important factor in the establishment of internal controls.

Vice President Broome explained that the University's internal control structure is broken down into centralized functions and decentralized activities. The overall policy development and guidance is maintained by the Office of the President. Certain functions cannot be decentralized; these include benefits, the treasury function, the General Counsel, and consolidated financial reporting. The majority of activities at the University – teaching, research, and public service – are carried out on a decentralized basis within individual campus departments. The academic, financial, and administrative support is also concentrated in these departments. The University's complex structure presents a challenge in terms of internal controls. The responsibility and accountability for control resides at the individual department level. Each department uses a single campus general ledger system, which is maintained by the central campus administrative offices. The campus administration reports this consolidated financial activity to the Office of the President, and the Office of the President publishes the UC Financial Statements.

Ms. Broome recalled that in 1996 The Regents had adopted the recommendations of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The document focused on three key objectives: the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable laws and regulations. In addition, there are five primary control elements: the control environment, risk assessment, control activities, information and communication, and monitoring. Vice President Broome outlined how the University had implemented The Regents' control initiative. The position of controller was created at each campus, and a director of controls and accountability position was established in the Office of the President. The controllers provided focused financial leadership for the implementation of a strong control program. They have met monthly since the establishment of the program in 1996. Most of the campuses have formed high-level steering committees to address areas of risk. Ms. Broome explained that a Business Officers Institute had been established to train personnel about risk assessment and the controls initiative. One feature of the training is a focus on case studies involving areas such as sexual harassment and discrimination.

Vice President Broome discussed the conceptual framework that had been developed for the management of risk. This framework recognizes two fundamental principles: that people use processes to achieve objectives and that understanding objectives, risks, and controls is essential to managing risk to acceptable levels of exposure. This has proven a successful model for risk assessment. The areas receiving priority attention under The Regents' control initiative include the effect on administrative functions resulting from growth. Over the past five years, most administrative departments have suffered budget reductions of 20 percent, posing a serious risk factor to maintaining the control environment. Vice President Broome also expressed concern about the effects of a decentralized environment. Other high-risk areas include sponsored research, stewardship of funds, health services, and external partnerships, including technology transfer. Ms. Broome outlined some of the key compliance activities, including the Clinical Enterprise Corporate Compliance Committee and the Research Compliance Initiative. There are various local campus efforts to strengthen research compliance programs, and a Joint Senior Vice President–Business and Finance and Vice Provost–Research task force was established in 2004 to address research compliance issues.

In response to a question from Regent Connerly, who observed that controls begin with reporting relationships, Vice President Broome explained that the campuses initiate the hiring process for the controller. She retains final say over the hiring decision. Regent Connerly asked how this involvement on the part of the Office of the President meshed with the concept of decentralization. Ms. Broome stressed that the campus controllers have a solid-line reporting relationship with the campus, while her interaction tends to be in the areas of policy development and systemwide controls.

Regent Hopkinson pointed out that the control objectives described by Vice President Broome did not address the issue of ethics; University policies should be reflected in the framework of internal control. University Auditor Reed noted that the control environment always addresses the ethics of the organization.

Mr. Reed presented an overview of the internal control challenges from an Internal Audit perspective, using a grid that defined both the elements and objectives of control. As described by Vice President Broome, the elements of control include the control environment, risk assessment, control activities, information and communication, and monitoring, while the overall objectives are accurate financial reporting, effective and efficient operations, and compliance with laws and regulations. Mr. Reed pointed out that there is an inherent challenge in a decentralized organization to establish a consistent control environment. The University's role as an academic institution also poses challenges. The research environment is fraught with volumes of regulatory requirements; compliance with these regulations takes place in the campus departments and organized research units that house research activities. With respect to risk assessment, University Auditor Reed noted that the notion is not formally established as a management activity; there is not a well-developed common understanding of what constitutes risk. Control activities are generally adequate, with the most frequent challenges being the separation of duties and adequacy of supervision, given the large number of small business units. Progress in this regard is being made at the Los Alamos National Laboratory. With respect to information and communication, there is a strong need for the new effort reporting system now under development which will ensure that funds are tracked to the correct contract or grant. Budget constraints have hampered the new business architecture, and information security challenges are constant threats. Business monitoring controls, including audit coverage, are generally reasonable for the objectives of financial reporting and efficient operations. There is a need for more monitoring of research compliance, which is the responsibility of the Principal Investigator.

4. **SUMMARY AND HIGHLIGHTS OF INTERNAL AUDIT AND EXTERNAL AUDIT AGENCY ACTIVITIES FOR THE YEAR**

University Auditor Reed reported that as of March 31, 2004, 80,000 hours had been expended on regular audit activities, while investigation hours were less than the plan and the prior year's. The fourth quarter, however, has shown a reversal in this trend. One hundred thirty audits and 85 investigation reports have been issued, and the prospects for completion of the 2003-04 plan are good. Mr. Reed provided a summary of the year's significant internal audit matters, beginning with the willed body program internal audit reviews at four health sciences campuses which had resulted from the illegal activities alleged to have occurred at the Los Angeles campus. No evidence of the misuse of donated material was identified. The programs vary in size, organizational structure, and funding support but have common internal control challenges and would benefit from more oversight. A predominant challenge to independent accountability results from a lack of the separation of duties due to staffing levels. Vice President Drake and former Governor Deukmejian serve on the committee charged with developing best practices for the University's willed body programs. A phase two audit is looking at how academic departments that receive donations account for, store, and return these materials.

University Auditor Reed then described the following significant audits which had occurred over the past year:

Laboratory Cost Allowability Audits: These audits are being carried out under a new program negotiated on behalf of the three national laboratories with the Office of Inspector General. Two audits are complete, with no questioned costs.

Casa de California: An audit was conducted of the acquisition of this property in Mexico City, and while no questions were raised during the audit, the fact that the property lies idle spurred renewed discussions of the plan for renovation and use.

UC Berkeley Administration and Compliance: The routine audit covered animal research, human subjects, and conflicts of interest. Substantial concerns about human subjects research practices were raised by the new Institution Review Board Director and are being addressed with outside assistance.

Los Alamos National Laboratory Subcontractors: Work performed by PricewaterhouseCoopers on a longstanding contractor issue resulted in questioned costs of $3.7 million. The laboratory is pursuing the claim process.

UC San Diego and UC San Francisco Veterans Administration Affiliations: Both campuses conducted audits assessing the business relationships, contract administration, research project administration, and joint appointments. The most significant ensuing issues were employment and research-compliance related. A white paper will identify issues that need to be addressed on a systemwide basis.

Lawrence Berkeley National Laboratory Property and Financial Management: This audit was discussed in some detail with the Committee at its September 2003 meeting.

UC Berkeley Intercollegiate Athletics Compliance: An audit was conducted of the corrective action agreed to by the campus that resulted from investigations leading to a five-year probation. The audit found that most of the corrective actions had been taken but that additional processes need to be developed and implemented to build an effective compliance program.

UC Davis Construction Audit: This audit identified a practice regarding the use of University employees to perform construction projects and led the University to propose a change to raise the limits for projects that can be handled internally under the State Public Contract Code.

UC San Francisco Account Reconciliations: An audit of balance sheet account reconciliations confirmed inconsistent practices for reconciling accounts. Standardized processes and ongoing monitoring is needed. Under the new controller, a plan to assure that this occurs is under way.

UC Santa Cruz Research Compliance: An audit of animal research, human subjects, and pre- and post-award administration concluded that the campus had designed effective, comprehensive, and well-managed processes to ensure research compliance.

LANL Computerized Maintenance Management System: An audit was performed at Los Alamos of the system that manages facilities under a contract with a third party. The overall conclusion was that controls are inadequate to ensure that facility maintenance is performed efficiently and effectively. Management agreed to increase functionality and correct system deficiencies identified in the audit.

Turning to investigations, University Auditor Reed reported that 115 investigations had been opened in 2003-04, with 22 meeting the criteria for reporting to the Senior Vice President–Business and Finance. Thirty-six percent of the allegations came from management and 61 percent from whistle blowers, of which 11 percent were hotline calls. The trend toward a higher percentage of complaints coming from whistle blowers is up over prior years, which could be a result of the implementation of the University's whistle blower policy.

University Auditor Reed discussed the following significant investigations which were completed over the past year:

UCSF Cashiering: The former cashier who embezzled $4.5 million has been sentenced to seven years in prison.

UCB Police: The investigation began as a review of alleged missing items from lost and found. Four civilian dispatchers have been terminated and are under prosecution for time sheet fraud after an investigation that also resulted in reprimands for others, including several sworn officers.

UCLA Financial Aid Procurement Card: The associate director of the financial aid office was terminated and the case referred to UCLA police after an investigation identified in excess of $20,000 in procurement card purchases that were not for University purposes. Supervisory review failed to detect the inappropriate expenditures.

UCB School of Public Health: Allegations of misuse of State funds provided from tobacco settlements were not sustained, although the business practices of the program director were criticized and additional evidence of conformity with the funds' intended purpose was recommended.

UC Riverside Fire Extinguishers: Allegations were received regarding improprieties in the Riverside campus fire extinguisher exchange program. It was also asserted that hundreds of fire extinguishers were missing, resulting in the need for additional purchases and additional cash payment to the vendor for extinguishers not available for trade-in as contemplated in the original pricing. It was sustained that hundreds of fire extinguishers were missing. There was no evidence of misdoing on the part of University employees.

UCSD Vendor Billings: A hotline caller allegation produced the finding that a vendor had overbilled the campus by approximately $105,000. The information was shared with other campuses, none of which identified similar problems with the vendor. To date, $12,600 has been recovered, and the remainder is being pursued.

LBNL Vendor Payments: As reported at the September 2003 meeting, an investigation triggered by a vendor disclosure revealed that a laboratory manager had made advance payments totaling $3 million to establish a "rainy-day fund." The $3 million plus interest was repaid, and the individual opted to retire rather than be terminated.

University Auditor Reed displayed a list of significant external audit activities for the year, noting that much of the activity continues to be focused on the national laboratories.

Mr. Reed reported that a new database was near completion that would capture every recommendation made from audits, investigations, or advisory services projects. Recommendations may be sorted by location, significance, type of control deficiency, and business area. The database should serve to facilitate communication with the Regents and will assist in tracking delinquent corrective actions.

Mr. Reed concluded his presentation by noting the development of a new annual report to be prepared by each of the thirteen audit departments which will include the following elements:

- Overall comments on the conditions of the control environment
- Assurance of independence of audit operations and unrestricted access
- A summary of observations, completion of Audit Plan, and coverage of high risks and core audit areas.

5. **UPDATE ON PROTIVITI RECOMMENDATIONS AND UNIVERSITY MANAGEMENT PROPOSED APPLICATION OF SARBANES-OXLEY**

Vice President Broome recalled that in 2002 the Committee had commissioned a study by the independent consulting firm Protiviti that resulted in a report presented in March 2003. One of the objectives of that study was an evaluation of the applicability and appropriateness for University adoption of the requirements of the Sarbanes-Oxley Act. In September 2003 University management provided a set of recommended actions designed to address the provisions of Sarbanes-Oxley and the Protiviti recommendations to the University. A chart was mailed to the Regents in advance of the meeting showing the status of those recommendations that were planned to be implemented or are in the process of implementation.

Ms. Broome noted that, under the topic "Qualifications of Audit Committee Members," management had recommended that the Committee consider identifying an advisor with the prescribed knowledge base and experience to provide broad technical advice. Committee Chair Novack suggested that consideration be given to tapping into the University's alumni to find an individual to serve in this role.

With respect to auditor retention and fees, Vice President Broome recalled that the engagement letter is signed by the Secretary on behalf of The Regents. Management agrees that the letter should be addressed to the Committee and executed by the Chair. Under Sarbanes-Oxley a five-year rotation is required for "lead" external auditors, with a five-year time-out period. UC management recommends that audit partner rotation should be addressed in connection with any extension of audit services beyond the initial contract period, with an expectation of rotation of the lead and reviewing partners after five years. A formal evaluation will be performed in conjunction with the reappointment of any firm when the initial term expires if the recommendation is to extend the firm's services.

In response to a question from Regent Lozano, Vice President Broome explained that higher education in general and the University in particular had adopted a seven-year retention period for external auditors. Regent Lozano suggested that this be so indicated in the "status" column of the report.

Sarbanes-Oxley requires that the CEO and CFO of a corporation must certify annual and quarterly reports stating that the financial reports contain no untrue statement or omission of material fact and fairly present the company's financial condition. The annual representation letter is signed by the President, the Senior Vice President–Business and Finance, and the Vice President–Financial Management. Representation letters are signed by CEOs and CFOs in connection with the financial statements of the five medical centers. Campus controllers sign a representation letter tailored to the campus. For 2004 this procedure will be expanded to include obtaining representations from chancellors and vice chancellors– financial administration, as well as the three national laboratory directors and CFOs or equivalent. Sub-certifications will be required from such areas of activity as development, student receivables, and campus foundations. To date, no University has adopted the Sarbanes-Oxley requirement, as it would be expensive and impractical.

In response to questions from Regents Hopkinson and Novack, Senior Vice President Mullinix noted that a committee had been constituted to develop a Universitywide ethics policy which will be presented to the Committee for consideration at the November or January meeting.

The Committee went into Closed Session at 10:10 a.m.

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The meeting adjourned at 10:45 a.m.

Attest:

Associate Secretary