The Regents of the University of California

COMMITTEE ON AUDIT
November 16, 2005

The Committee on Audit met on the above date at the Clark Kerr Campus, Berkeley Campus.

Members present:	Regents Gould, Hopkinson, Lozano, Marcus, Parsky, Rominger, Ruiz, and Schilling; Advisory member Oakley; Financial Expert Advisor Vining
In attendance:	Regents Dynes, Juline, Preuss, and Rosenthal, Regents-designate Ledesma and Schreiner, Faculty Representative Brunk, Secretary Trivette, Associate Secretary Shaw, General Counsel Holst, University Counsel Thomas, Acting Provost Hume, Senior Vice Presidents Darling and Mullinix, Vice President Broome, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 4:25 p.m. with Committee Chair Marcus presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of September 22, 2005 were approved.

2. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2004-2005**

In accordance with the Schedule of Reports, the **Annual Report on Internal Audit Activities, 2004-2005** 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 the annual report on internal audit activities for 2004-05. He noted that no circumstances had been identified that the auditors believe represent a material deficiency in internal controls. In addition, there were no circumstances identified in which management's decisions resulted in the acceptance of unreasonable levels of risk. Managers of the University are cognizant of their responsibility for internal controls and actively participate in the identification of risks. There is respect for the objectives of the internal audit program, and a high level of cooperation is received. There was no interference with either the accomplishment of the audit or internal audit's reporting to The Regents.

Mr. Reed displayed a chart showing the distribution of audit effort by service type over the past seven years and observed that the primary emphasis continues to be on the program of regular audits. It also displays the rise in investigation demands in more challenging economic times and the resultant effect on internal audit's ability to devote resources to advisory services.

Mr. Reed recalled that the Audit Tracker system had been developed in 2004 to provide a means of aggregating all of the audit recommendations that led to agreed-upon Management Corrective Action plans (MCAs) designed to improve controls. This aggregation allows internal audit to track and to communicate the status of open recommendations and MCAs in a timely fashion. The year began with 2,821 MCAs, and the current open inventory is 1,189.

Referring to a chart which compared MCAs with audit hours spent, Regent Juline observed that 15 percent of the MCAs related to research and compliance, while only 9 percent of the hours were devoted to this area. He asked if such a discrepancy would cause internal audit to revise its priorities. University Auditor Reed acknowledged that internal audit views research compliance as a major risk for the University; these results suggest that even more time might be devoted to this area. He noted that internal audit is working with Vice Provost Coleman and his staff on their efforts to establish a research compliance program.

Mr. Reed displayed a chart showing the status of all 6,635 Management Corrective Action plans since the Audit Tracker system was initiated, noting that the 87 percent rate of closure of the high-rated MCAs reflects the fact that these are the items with the greatest urgency to bring to closure. While the majority of the open items are not yet due, 67 are past due. These past-due issues have been brought to the attention of senior management, and active resolution plans are in process. The goal of reducing these items to a negligible number is clearly understood and accepted by managers responsible for addressing these items. Regent Juline expressed concern that some of these matters had been open for two to three years, including the requirement that University employees receive training in conflict of interest administration. Mr. Reed explained that in prior years funds for this program were not available; training is being developed in response to Assembly Bill 1939, which required the California State University to put such training in place and urged the University of California to do so. It is anticipated that the training will be available in February 2006. In response to a further question from Regent Juline with respect to the ultimate authority for the past-due MCAs, Mr. Reed explained that they come to the attention of the campus audit committees, which are chaired by a vice chancellor, and disclosed to the chancellor. Regent Juline suggested the need for more follow-up activities. University Auditor Reed confirmed that the 67 open items would be tracked to their extinction. In response to a question from Committee Chair Marcus, Mr. Reed noted that internal audit no longer makes unilateral recommendations with respect to corrective actions. Rather, they are actions that have been committed to by management. The ranking of each MCA as high, medium, or low is determined in the local context.

University Auditor Reed outlined for the Committee the investigation activities that had taken place in 2004-05 by source and complaint method. The majority of allegations continue to be received from UC employees and managers. Reports received through the hotline service or other sources remain anonymous in 34 percent of the complaints received. In response to a question from Regent Hopkinson, he noted that 52 percent of the anonymous complaints are not substantiated. When allegations are made by an identified party, there is more opportunity to pursue the details of the complaint.

University Auditor Reed concluded his presentation by observing that internal audit faces the challenge of maintaining adequate staffing levels, given the demand for auditors in light of the Sarbanes-Oxley legislation. Financial Expert Advisor Vining reported that his greatest concern with respect to the audit program had been the issue of the University's ability to attract qualified staff. Private accounting firms are making aggressive recruitment efforts and are able to offer higher salaries. The turn-over is occurring among those people who are most qualified to move to private industry. Mr. Reed added that the staffing level is down by 12 positions across the University. Stability has been maintained at the auditor director level. The internal audit program is not unique in its inability to offer competitive salaries.

3. **HUMAN RESOURCES ACCREDITATION PROGRAM**

Senior Vice President Mullinix recalled that, in response to concerns regarding HR policy issues, Human Resources and Benefits is putting in place a new HR assurance model that includes having a single point of accountability for HR policy assurance. The model will include clearly articulated standards, mechanisms that provide regular self-assessments at the campuses, laboratories, and medical centers, and external peer review for validation purposes.

UC is partnering with the National Academy of Public Administration (NAPA) to develop a robust self-assessment process. This effort will include standards in six broad HR areas, such as compensation and benefits, workforce planning and employment, and employee and labor relations. In addition to assisting with the development of a systematic process, NAPA will act as the external reviewer.

As UC locations complete annual self-assessments against the standards, they will be demonstrating assurance and compliance with all applicable federal, State and local laws and regulations, UC policy and contract requirements, and ultimately will become accredited by NAPA.

Associate Vice President Boyette reported that in 2002 the Lawrence Berkeley National Laboratory presented a proposal to the Department of Energy for restructuring DOE's oversight approach for performance management, which included human resources. The assurance process consists of three major components: having defined performance standards, a rigorous self-assessment process, and external peer reviews for validation and assurance. The result was intended to meet or exceed Department of Energy performance management standards. The DOE accepted the laboratory's proposal for an HR department accreditation model. This process played a role in the University's winning bid for the continued management of the Lawrence Berkeley National Laboratory.

The intention is to expand the process throughout the University. It will include the appointment of an HR assurance officer at the relevant campus, laboratory, or medical center. An external peer review will be asked to validate HR practices and procedures. The new process is designed to assist the Regents in their oversight role in the HR area.

Representatives from the National Academy of Public Administration will be invited to the Committee's January 2006 meeting.

4. **ANNUAL REPORT OF THE EXTERNAL AUDITORS FOR THE YEAR ENDING JUNE 30, 2005**

Mr. Mike Schini, the engagement partner for PricewaterhouseCoopers, presented the external auditors' annual report, noting that the audit of the financial statements of the University is conducted in accordance with auditing standards generally accepted in the United States. Because the University is a recipient of federal funds, the audit is also conducted under Government Auditing Standards. There were no significant changes in scope, and the auditors rendered an unqualified opinion on the financial statements.

During the year ended June 30, 2005, the University adopted Governmental Accounting Standards Board (GASB) Standard No. 40, Deposit and Investment Risk Disclosures, which required extensive additional disclosures on investments. Also during the year ended June 30, 2005, the UC Berkeley Foundation changed the method by which it accounts for certain external third-party trusts to record their estimated fair value. This change was made to conform to the policies of the University and is recorded as a cumulative effect to the foundation's opening net assets.

GASB No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries, which was also adopted in 2005, requires an evaluation of prominent events or changes in circumstances to determine whether an impairment loss should be recorded. The effect of the implementation of GASB No. 42 was not significant for the University's net assets.

During the year ended June 30, 2005, the University increased its capitalization threshold on equipment for new purchases to $3,000. The effect of this change was not material to the financial statements.

Mr. Schini observed that, as with any financial statements, the financial statements of the University contain judgments and estimates. The auditors are required to communicate annually to The Regents the process used by the University in developing particularly sensitive accounting estimates. These estimates are based either on historical data or, in the case of gifts, upon the University's independent estimate of fair value. The auditors are also required to report any adjustments that were proposed to the University which have been recorded in the preparation of the financial statements and have not been recorded but have been evaluated for materiality. As a result of the audit, adjustments were discussed with management. There was one unrecorded adjustment which relates to the presentation of medical center bad debt expenses.

Financial Expert Advisor Vining commented on the professional relationship between PricewaterhouseCoopers and University management, each with their own points of view. Committee Chair Marcus acknowledged Mr. Vining's contributions to the work of the Committee.

Regent Gould observed that the required communications from the auditors had made reference to the fact that GASB had recently issued guidance on the preferable accounting for post-employment benefits, such as retiree medical costs. Mr. Schini recalled that nearly all GASB entities have treated such costs on a pay-as-you-go basis. The University will be required to change to an accrual basis in the year beginning July 1, 2007, which will result in significant additional accrual basis expense to record and the disclosure of a significant liability.

Turning to the management letter to The Regents, Mr. Schini described an observation related to information technology reviews at a number of campuses and medical centers. The auditors noted that user access to applications and systems is not reviewed as frequently and thoroughly as expected to ensure that access is commensurate with existing roles and responsibilities. Management has committed to the performance of a periodic review of applications users.

At the Committee's request, PricewaterhouseCoopers performed extended audits of the Department of Energy laboratories. The materials which were mailed to the Regents contained detailed descriptions of the work performed at each location. While the largest number of comments related to the Lawrence Berkeley National Laboratory, the laboratory has addressed significant issues over the past several years. Mr. Schini felt comfortable with the current financial management team and its ability to conclude outstanding reconciliations. Most of the recommendations made to management at the Lawrence Livermore National Laboratory have been addressed. Mr. Schini noted that one issue at both Berkeley and Livermore pertained to post-employment benefits because the government has been paying these benefits on a cash basis. A question which arose in connection with the continuation of the University's management contracts was which entity would be responsible for these payments if the contracts were not renewed. Berkeley was the first laboratory to negotiate for post-employment benefits in its renewal contract. The Los Alamos National Laboratory had the fewest comments, which represents significant process given its history.

In response to a question from Regent Hopkinson, Mr. Schini explained that the auditors do not have access to secured areas and secured contracts at the national laboratories. Other than that, the auditors feel comfortable that the University has focused adequate attention on its reporting to the DOE. The new audit process has helped in this regard.

Regent Hopkinson asked whether the Regents should be concerned about anything that was uncovered during the course of the audits of the three national laboratories. Mr. Schini would be concerned if the recommendations for corrective action were not addressed over the coming year. The most significant items in 2005 related to a systems change implemented by the DOE. Vice President Broome noted that she participates in a conference call with the three laboratory directors each month.

Regent Hopkinson asked for an interim report in six months that would assure the Regents that required corrections are being undertaken. The information should also be sent to the Department of Energy.

The meeting adjourned at 5:20 p.m.

Attest:

Secretary