

The Regents of the University of California

COMMITTEE ON AUDIT

March 16, 2005

The Committee on Audit met on the above date at Covell Commons, Los Angeles campus.

Members present: Regents Blum, Hopkinson, Lee, Lozano, Novack, Parsky, Ruiz, and Sayles;
Advisory member Brunk

In attendance: Regent Ornellas, Regents-designate Juline and Rosenthal, Faculty Representative Blumenthal, Associate Secretary Shaw, University Counsel Thomas, Treasurer Russ, Provost Greenwood, Senior Vice President Darling, Vice Chancellor Broome, Chancellor Córdova, University Auditor Reed, and Recording Secretary Nietfeld

The meeting convened at 2:15 p.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 January 19, 2005 were approved.

2. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2005**

The President recommended that the scope of the external audit of the University for the year ending June 30, 2005, including the expanded external audit coverage of the National Laboratories, be approved.

[The Audit and Communications Plan 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 annual external audit plan of The Regents' auditor provides for a financial audit of the University of California, including 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, audit procedures at the National Laboratories, and the Federal Grants and Contracts (A-133) audits.

At the November 2002 meeting, The Regents approved the appointment of PricewaterhouseCoopers LLP (PwC) as external auditor for the three-year period beginning with the fiscal year ending June 30, 2003. The total cost of the audit for the fiscal year ending June 30,

2005 is \$3,275,045, which includes out-of-pocket expenses, required audit scope changes for 2005, and the continuation of the expanded scope of work at the National Laboratories.

Audit Scope at the National Laboratories

It is recommended that PricewaterhouseCoopers perform “agreed-upon procedures” similar to the scope of work performed at each laboratory last year. The scope of the work would focus on the higher risk areas. The incremental fee for these recommended procedures is \$343,000, including out-of-pocket expenses, and is included in the total cost of the audit.

Audit Scope Changes for Fiscal Year 2005

Mr. Mike Schini, the engagement partner for PricewaterhouseCoopers, explained that scope changes for 2005 are required as a result of the University’s implementation of new Governmental Accounting Standards Board (GASB) Statements Nos. 40 and 42, a required expansion of work associated with the NCAA audit procedures, and the first-year audit of the new 457(b) defined contribution plan. He noted that the size of the University’s financial statements had grown significantly over the years as a result of these GASB requirements.

Changes in Government Auditing Standards include a new requirement to consider the possibility of “abuse” in reviewing award charges, which would include charges that may not be necessary to an award, such as attending a conference that was not essential to research. For this reason, it may be difficult to determine whether a charge constitutes abuse. The adoption of new NCAA legislation related to the agreed-upon procedures for intercollegiate athletics represents a significant expansion of the required effort. The previous NCAA audit guide was focused largely on disclosing the total revenues and expenses of the intercollegiate athletics programs; the new effort will include certain compliance aspects as well. It will require a review of coaches’ contracts, W-2 forms, and vendor contracts and determining whether certain policies are in compliance with NCAA rules.

The new California Not-For-Profit Integrity Act is recently adopted legislation that adds significant requirements for charities based in California. While educational institutions are exempt from most aspects, the act generally would apply to foundations. The new requirements include, for organizations above a certain threshold, the establishment of an audit committee, rules relative to audit committee membership, and strict regulations relative to the use of fund raisers.

The Public Company Accounting Oversight Board standard AS 3 increases the expectation as to the level of documentation needed to support an audit in accordance with PCAOB standards. PwC uses one standard for both public and non-public audits and, as a result, the required documentation for the University is geometrically expanded in comparison to any prior year.

GASB Statement No. 40 requires the University to expand significantly the footnote disclosure to address common risks in investments and securities lending activities. Implementation of Statement No. 40 will have no effect on the University's net assets or changes in net assets. Statement No. 42 requires an evaluation of prominent events or changes in circumstances to determine whether an impairment of capital assets has occurred and should be recorded, and that any insurance recoveries be netted with the impairment loss. In addition, GASB Statement No. 45, which is effective for the year ending June 30, 2008, will have a major impact on the reporting of post-employment benefits. This will result in a substantial liability for the University required to be accrued over a period of time.

Mr. Schini recalled that when the audit plan was adopted for the year ending June 30, 2004, it included expanded audit coverage of the Department of Energy laboratories. The firm developed three agreed-upon procedures reports, one of which was included with the materials that were distributed to the Regents. Laboratory management has taken corrective action as a result of recommendations contained in the reports.

Mr. Rick Wentzel, the A-133 compliance partner, explained that one of the steps taken by PwC in the course of the audit is to interview both management and line employees regarding the instance of fraud, including the misrepresentation of financial data. He asked that if any Regent had concerns to raise with respect to fraud, these concerns be communicated through the Committee chair.

Regent Parsky suggested that the Committee would want the auditors to ensure that any instances of fraud that may have occurred had been corrected. Vice President Broome confirmed that any reports of fraud to the University are turned over to the external auditors. Mr. Wentzel noted that campus auditing teams are asked to pay special attention to areas where any concerns have been raised.

Regent Lozano asked about the external auditors' familiarity with the physicians in the clinical compensation plan. Ms. Peggy Arrivas, a health-care partner, explained that the process involved looking at the University's controls over the contracting process and noted that extra attention could be paid to this process in the upcoming audit. Regent Lozano asked that PricewaterhouseCoopers discuss the prioritization of this issue with Committee Chair Novack.

Regent Lozano raised the issue of intellectual property and any third-party business arrangements that University researchers may have. Mr. Schini recalled that several years ago a corporation had made a major donation of intellectual property to the University and the external auditors undertook an understanding of how it should be valued. The area of conflict of interest is examined on a routine basis.

Regent Hopkinson posed a series of questions to the representatives of PricewaterhouseCoopers about the following: the six percent increase in audit fees; the manner in which the University handles cash and accounts payable; the proposed billing

schedule for the fiscal year; and the reason the audit report on the Los Alamos National Laboratory had been distributed to the Committee with the agenda materials. She referred to the finding in the report that “of the \$57 million in unbilled and outstanding Other Federal Agency accounts receivable at June 30, 2004, [the auditors] received subsequent cash receipts support for \$6.5 million.” She requested that there be scheduled time for the Committee to review in greater detail the auditors’ reports on the National Laboratories. These materials should also be provided to the Committee on Oversight of the Department of Energy Laboratories. Committee Chair Novack recalled that the reports on all three of the laboratories had been distributed previously, but he acknowledged that no significant discussion of the issues raised had occurred. He requested that the reports on all three of the laboratories be provided to the Committee and that, in response to Regent Hopkinson’s request, a discussion item be added to the Committee’s July agenda to review and update the auditors’ recommendations and management’s responses.

In response to the issues raised by Regent Hopkinson, Mr. Schini explained that the six percent was intended to address ongoing compensation increases at PricewaterhouseCoopers. The fee was established in 2002. Vice President Broome added that the three-year contract had protected the University against any significant fee increases. Turning to the issue of cash and accounts payable, Mr. Schini commented that at year end the auditors look specifically at cash reconciliations and payments made from accounts payable. He stressed, however, that the audit is performed on an annual basis. As such, the Regents must rely upon the University’s system of internal controls. In response to a comment from Regent Hopkinson, Mr. Schini explained that the auditors do not set a fixed amount below which they will not investigate because that would provide too much information to the auditee. The fixed billing schedule referred to by Regent Hopkinson is intended to be representative of the effort expended during each period.

In response to a question from Regent-designate Rosenthal regarding student organizations, Mr. Schini responded that any organizations whose revenues and expenditures go through the University are subject to an audit. There are no areas of the audit that would impinge upon the privacy of individual students. If anything unusual were discovered in the course of the audit, the external auditors would address their comment to counsel for the University.

In response to a comment from Regent Lee, Mr. Schini recalled that a Regents Only session of the Committee is held on an annual basis to provide the Regents with an opportunity to meet privately with the external auditors. He pointed out, however, that these sessions must be confined to personnel matters. The auditors do not hesitate to communicate any concerns to the chair of the Committee throughout the year.

Upon motion duly made and seconded, the Committee approved the President’s recommendation and voted to present it to the Board.

3. SUMMARY OF CURRENT QUARTER INTERNAL AUDIT ACTIVITIES, 2004-05

University Auditor Reed expressed his appreciation to Committee Chair Novack, President Dynes, and Senior Vice President Mullinix for their attendance at the All Auditors Conference which had been held in February, attended by over 120 auditors from throughout the system. He recalled that in January he had commented on personnel matters which influence the ability to carry out the internal audit program. Since that time, ten auditors have been hired, while only one was lost. Mr. Reed continued that, as a result, his concerns about the ability of internal audit to carry out the plan for the year had been somewhat reduced. He was confident that any campus amendments to the plan were being done on a risk basis.

Mr. Reed recalled that Regent Hopkinson had raised the issue of cash and accounts payable, noting that cash is collected at thousands of locations throughout the University, from parking lots to co-payments at clinics. Internal audit pays attention throughout the year to these collection points, the processes for the receipt of cash, and the timely deposit of cash. He emphasized that the primary internal control role is played on the campuses by coordinators who operate under a cashiering policy. The goal of internal audit is to assure that this policy is being followed at the department level. University Auditor Reed recalled that accounts payable had been a primary source of abuse for several defalcations, including the establishment of a fictitious vendor. Accounts payable is considered to be a core business activity and as such is reviewed on a three-year cycle.

University Auditor Reed reported that the internal audit plan for 2005-06 was being developed and would be presented to the Committee at the May meeting. During this process, a campus internal audit department typically conducts interviews with senior officials about their concerns. Hours will continue to be budgeted for audits of policies that directly enforce ethical principles.

Since the January 2005 meeting there have been no audit reports that produced any significant findings. Internal Audit is undertaking an improved process of reporting to the Regents, using a tool known as Audit Tracker, which is intended to ensure that the auditors report to the Committee risks that have been identified on which management has not taken timely action. He recalled that in November he had reported that in the prior fiscal year there had been reports issued with over 2,000 findings and recommendations; a status report will be provided in May.

Mr. Reed commented briefly on two matters under investigation. He reported that there had been anonymous allegations about the Dean's Office at the San Francisco campus; due to the serious nature of the case, Mr. Reed explained that he was handling this investigation. The dean and the campus are providing complete cooperation. A second matter involves pharmaceutical purchasing at the Los Angeles campus. There was an allegation that drugs could be purchased more cheaply by a particular unit by not participating in the vendor contract. Internal audit reviewed whether or not there had been any conflicts of interest

involved in the initial letting of the contract. The audit report concluded that there had not been any purchasing improprieties. He stressed the need to compare the totality of the contract, which includes guaranteed delivery and guaranteed availability. Internal audit recommended that, in conjunction with any renewal of the contract, it should be demonstrated that cost savings had been achieved.

University Auditor Reed concluded his presentation by noting that internal audit continues to work towards completion of the matter previously discussed with the Committee pertaining to an employee of the epidemiology department at the Irvine campus. Negotiations with the funding agencies are ongoing; Mr. Reed anticipated that a full report would be issued soon.

In response to a question from Regent-designate Juline, University Auditor Reed confirmed his expectation that no high-risk audits would be dropped from the internal audit plan due to the availability of resources.

4. **PROCEDURE FOR APPOINTING OUTSIDE EXPERT TO THE AUDIT COMMITTEE**

Committee Chair Novack recalled that at previous meetings, it had been suggested that the Committee consider seeking outside experts who could lend support to the Committee's deliberations. In response to this suggestion, and modeled on the Investment Advisory Committee, the following steps were developed for appointing up to three expert advisors who would serve staggered, three-year terms of not more than two terms each.

Selection Process

- A. Applications and nominations will be solicited and sent to the Office of the Secretary.
- B. The Chairman of The Regents will appoint a screening committee to review candidates. Screening will be done by the Chair of the Committee on Audit, the Senior Vice President-Business and Finance (who will solicit comments from others as appropriate), the General Counsel of The Regents and/or his designee, and the Secretary of The Regents.
- C. The screening committee will assess the following:
 - Professional credentials and relevant experience.
 - Potential conflicts for the candidate or the candidate's family members.
 - Affinities or connections with the University and its related entities.
 - References and background checks done through selected public sources.

- D. Following the screening process, a review committee comprised of the Chairman of the Board and the Chairs of the Committees on Audit and Finance will consider the acceptable candidates and conduct any necessary follow up.
- E. The nominees will be determined and will be contacted to confirm their willingness to serve and to meet confidentiality requirements, and they will be informed of the liability and indemnifications issues involved.
- F. The review committee will recommend to the Nominating Committee one or more advisors for a three-year term.

Regent Novack reported that three applications for the position had been received from alumni. Chairman Parsky will appoint a group to review the applications and return to the Committee with a proposal, hopefully at the May meeting. The intention would be to make the appointment effective July 1, 2005. The Office of the General Counsel is drafting a modification to The Regents' indemnification policy in order to include the outside expert.

Regent Ruiz recalled that PricewaterhouseCoopers had provided among the agenda materials a white paper on best practices for audit committees. He suggested that the Committee might wish to ask the external auditors for assistance with a review of the University's audit process, which he found to be confusing. Committee Chair Novack recalled that the appointment of outside experts was in response to a report issued by Protiviti pertaining to best practices covered by the Sarbanes-Oxley legislation. Regent Ruiz believed that the outside expert could provide input with respect to internal audit. Regent Novack noted that they will be asked to focus on the financial aspects of the program.

Regent Hopkinson recalled that, also in response to the Protiviti report, the Bylaw pertaining to the responsibilities of the Committee had been restructured. Regent Ruiz suggested that the Bylaw was limited in its scope. Committee Chair Novack underscored the fact that University Auditor Reed provides timely updates to the Committee. University Auditor Reed offered to review details of the University's internal audit program with Regent Ruiz.

Regent Hopkinson suggested that it would be helpful to have a list of all the action items contained in the Protiviti report, with the current status of each.

Committee Chair Novack concluded the meeting by observing that the statement of ethics proposed by the Committee was under review by the Academic Senate. In addition, he has been working with Regent Preuss on the issue of The Regents' responsibility for security at the National Laboratories. He has had the opportunity to review some of the reports that were issued by the Department of Energy. Regent Parsky suggested that any Regents wishing to see these documents make a request to the Office of the President.

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The meeting adjourned at 3:10 p.m.

Attest:

Associate Secretary