The Regents of the University of California

COMMITTEE ON AUDIT
November 16, 2006

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

Members present: Regents Island, Lozano, Ruiz, Schilling, and Varner; Advisory member Oakley, Expert Financial Advisor Vining

In attendance: Regent Johnson, Regent-designate Brewer, Acting Secretary Shaw, Acting General Counsel Blair, Provost Hume, Executive Vice President Darling, Vice President Broome, University Auditor Reed, and Recording Secretary Bryan

The meeting convened at 12:10 p.m. with Committee Chair Ruiz presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of September 20, 2006 were approved.

2. **ANNUAL REPORT OF EXTERNAL AUDITORS FOR THE YEAR ENDED JUNE 30, 2006**

The President recommended that the Committee on Audit accept the *Annual Report of External Auditors for the Year Ended June 30, 2006* on behalf of The Regents.

Vice President Broome recalled that the objective of The Regents' external auditors in performing the basic University audit is to render an opinion on the University's financial statements. The auditors also report their observations and make recommendations with regard to accounting procedures and controls. In addition, consistent with the prior year, the Committee on Audit approved an expanded scope of work at each of the national laboratories. The annual report submitted by The Regents' external auditors, PricewaterhouseCoopers LLP, contains Required Communications to the Board of Regents; the Management Letter, containing representative internal control comments by the auditors from the financial statement audit; and reports on the agreed-upon procedures performed at each of the national laboratories.

Mr. Michael Schini, the engagement partner, discussed the report. He recalled that PricewaterhouseCoopers conducts an external audit of the financial statements and performs additional tests of the University's compliance with federal laws and regulations with the purpose of reporting on the University's compliance with internal controls related to federal programs. The audits are conducted in accordance with generally accepted auditing standards and government auditing standards. The audit is directed primarily toward determining whether the financial statements are presented fairly. This year, the auditors concluded that they are and rendered an unqualified opinion.

Mr. Schini recalled that during the year, the University was required to adopt a new accounting standard called GASB 47, accounting for termination benefits. The effect was not significant. He noted that there are numbers in any set of financial statements that are subject to estimate. The external auditors found these estimates to be reasonable and consistent. GASB allows governments to account for post-employment benefits such as retiree medical costs on a cash basis. Starting in July 2007, however, the University will be required to account for post-employment benefits on an accrual basis. The University would need to accrue an estimate of future medical costs that it might pay for a retiree over that retiree's expected life.

Mr. Schini reported that the PricewaterhouseCoopers audit is not directed primarily at detecting fraud, but the auditors do conduct procedures to disclose indicators or instances of fraud. Nothing came to their attention in connection with the audit that was not known to management. There is also a process to track and accumulate adjustments. To the extent the external auditors become aware of proposed adjustments, the University's practice is to book everything that is known. There were no unbooked adjustments. No internal control items were found to be a material weakness or a significant reportable condition. Overall, the audit this year was uneventful. Management was well-prepared throughout the campuses, medical centers, and foundations.

Ms. Elaine Garvey, of PricewaterhouseCoopers, addressed the Management Letter, noting that in May 2007 there will be a new auditing standard related to how internal control matters are communicated to audit committees. It is effective for all non-public entities. The new standard aligns more closely the definitions and reporting mechanisms for internal controls to those in the public company environment. The new auditing standard requires internal control observations to be categorized as a control deficiency, a significant deficiency, or a material weakness. The thresholds for those categories are very low. The potential impact of this standard is that there will likely be more matters communicated to audit committees that are classified as significant deficiencies and potential material weaknesses because of the lower threshold and the prescriptive framework for classifying the controls. The Management Letter comment on this change suggests actions for the University to put it in the best possible position when the new standard takes effect. Vice President Broome reported that, to address this change, the external auditors discussed the meaning of the new standard with all campus controllers, CFOs from the medical centers, foundations, and laboratories, directors of controls and accountability, and the internal auditors. All attendees were instructed to review with their PWC representatives the key controls that the external auditors rely upon in auditing the books and records.

Upon motion duly made and seconded, the Committee accepted the *Annual Report of External Auditors for the Year Ended June 30, 2006* on behalf of The Regents.

3. **ANNUAL REPORT ON INTERNAL AUDIT ACTIVITIES, 2005-2006**

In accordance with the Schedule of Reports, University Auditor Reed presented the *Annual Report on Internal Audit Activities 2005-2006*. He reported that the internal auditors did not identify any condition considered to be a material control deficiency nor any circumstances in which management decisions resulted in the acceptance of unreasonable levels of risk. The auditors met with no interference with respect to the accomplishment of their tasks or their responsibility to report to The Regents. Management throughout the University participates in the identification of risks and works with internal audit collaboratively to address those risks through the audit planning process and the conduct of audits. Management has been comfortable seeking internal audit advice on control matters and on business matters with control implications.

Mr. Reed noted that the internal auditors spent 12,000 hours during the year on compensation and travel and entertainment for the Senior Management Group, representing about 10 percent of the total effort on regular audits. There were 700 audit reports, investigations, and advisory services products issued during the year, containing more than 1,600 recommendations for improvements in controls. There was a substantial decline in investigation hours. The volume of investigations approximated the previous year's.

Mr. Reed reported that, generally, internal audit is adequately staffed. Staff was at 84 percent of authorized capacity for the year, which equates to 13 fewer employees than anticipated. On average, there is one auditor per $170 million of expenditures. The auditing staff spent a large portion of its time on financial management, information technology, and communications, with the remainder of its time distributed in accordance with assessed risk. The audit tracker system assesses whether the recommendations made by the auditors have been accepted by management and implemented on a timely basis. Last year began with 2,600 open recommendations. By the end of the year the number had decreased to 1,100. There were 1,600 new recommendations issued but 1,900 were closed, reducing the inventory further to 859 open items. Overall, 89 percent of the recommendations that were made are closed, 11 percent remain open. Each recommendation is categorized as high, medium, or low risk need. Open, high-risk items that are past due are communicated to The Regents. There are 139 open items, of which 103 are not yet due but 36 are past due, some substantially. Although that represents a substantial reduction from the previous year, the goal is to have zero open high-risk, past due items. He reported that all open items are receiving appropriate management attention.

Mr. Reed reported that 71 percent of the investigations that internal auditors undertake arise from things that are reported by management and other University employees. Indications are that people are comfortable coming forward to report their observations to management.

The University Auditor and campus and laboratory internal audit directors establish a strategic plan every two years to provide guidance to the audit program leadership. The plan identifies goals such as providing operational excellence, good stakeholder and client relationships, and innovative service. Initiatives include improving internal reporting and communications and identifying partnership opportunities for corporate governance.

4. **REVIEW OF AUDIT GOVERNANCE DOCUMENTS**

University Auditor Reed presented a brief overview of the University of California Audit Program governance documents, which include Bylaw 12.1 – Committee on Audit, Internal Audit Mission and Charter, Outline of UC Audit Management Plan, and Policies on Dual Reporting. Through the mission and charter, The Regents gives the internal auditors authority to look at any record, enter any office, inspect anything, and have access to all employees and University records. The outline of the audit management plan lays out some things that the external and internal auditors do and has important provisions to guarantee their independence. The audit director on a campus reports functionally to The Regents through the University Auditor and administratively to the campus. Local campus management may not terminate the audit director; only the President may do this, upon the recommendation of the University Auditor. The University Auditor may not be terminated by the President or University management but only by The Regents. The audit governance documents were reviewed last in 2004. With the announcement that the audit and compliance functions in the Office of the President would be merged, it became apparent that a discussion should take place about the role of the Committee on Audit in relation to compliance and other evolving best practices in audit committees.

University Counsel Thomas reported that she would recommend not changing the Bylaw governing the Committee's responsibilities until there is an opportunity for some of the other governance issues to settle into place. She advocated proposing to the proposed Regents Committee on Governance a new name for the audit committee. The proposed new name would be Committee on Ethics, Compliance, and Audit or Committee on Compliance and Audit. It is suggested that the committee have a separate charter, designed to interpret the Bylaw, which would be updated annually. A draft charter addresses the Committee's responsibility with regard to the internal audit program, its relationship with the external auditors, the issue of compliance, and other functions as assigned by the Bylaws, the charter, or The Regents. She suggested that the Committee on Audit receive and review the annual report on the University's risk management program, which would go also to the Committee on Finance. Once the Committee approves it, the charter should be referred to the Committee on Governance for review. That Committee would forward it to the Board.

Financial Expert Advisor Vining believed that establishment of the lower threshold for various financial reporting and control issues, as discussed during the report on the financial statements, may have an impact on the audit plan. University Auditor Reed believed that it was too early to know. He reported that there is a plan in place to identify the key controls on the campuses and validate that they are in place. If may be useful for the internal auditors to audit the existence of those controls in advance of PricewaterhouseCoopers' audit.

Faculty Representative Oakley recalled that the 2004 Internal Audit Management Charter gives the Internal Audit Office full, free, and unrestricted access to information including records, computer files, property, and personnel of the University in accordance with the authority granted by the Board's approvals of the charter and applicable federal and State statutes. Except where limited by law, the work of Internal Audit is unrestricted. He observed that many employees and faculty use their University computers as their sole connection to the internet. The Committee on Faculty Welfare revised its electronic communications policy to reflect University policies. It reflects the right balance between the University's need to know how its equipment is being used and its right to conduct random sweeps by crawlers and the like, but it has express reservations of residual privacy rights that protect University employees from having to sacrifice all privacy on the whim of another University employee – a scenario that would be unacceptable to the faculty. University Auditor Reed responded that the electronic communications policy lays out procedures for consented and unconsented access to electronic records. It states that auditors in the course of conducting investigations are excepted from that policy by virtue of this authority. In the conduct of investigations, access to people's e-mails can be critical to disclosing conflict of interest and the conducting of outside business on University time. That policy was amended to add that when audits are conducted in an official investigation, exceptions to the policy may be sought. Professor Oakley maintained that the scope of Internal Audit as written does not stipulate that access is allowable only in the scope of an investigation and sets no standards for what triggers an investigation. It is subsequent to the Electronic Communication Policy and, when exercised by an audit official, would repudiate all of the protections in that. There needs to be some standard for when an investigation is appropriately commenced.

Regent Island was hopeful that the General Counsel's Office could suggest a major revision to the charter that addressed Professor Oakley's concerns and find the appropriate balance between The Regents' fiduciary responsibilities and the expectations of University employees of a certain level of privacy. Mr. Reed agreed that it was appropriate to have the issue considered at the Committee level. If the auditors' access is going to be restricted in any way, it should be with Regental approval as opposed to the creation of a management policy. Mr. Vining commented that if the result of a change to the charter is the evisceration of the auditors' ability to investigate, there will be serious complications with complying with accounting standards that may effect the University's ability to get its University's financial statements certified.

Regent Lozano commented that she needed more information about what the ethics component would entail if the word "ethics" were added to the Committee's title. She believed that systemwide there were likely ethics programs that go behond the statement of ethical values adopted by The Regents in May 2005.

Committee Chair Ruiz noted that, once assembled, suggestions for changing the name of the Committee on Audit and for addressing all the other concerns that had been discussed would be presented to the proposed Governance Committee for its review.

5. **UPDATE ON ETHICS ROLL-OUT STRATEGY**

University Auditor Reed discussed the status of the Ethics Briefing. The purpose of the Briefing is to familiarize UC employees with the Statement of Ethical Values and Standards of Ethical Conduct that were adopted by The Regents in May 2005. A web-based training program was developed to reach the workforce. The 30-minute training will raise people's awareness about the University's standards. The training was rolled out to the Office of the President and selected employees on November 8. While as of November 15, compliance had reached 30 percent, the target is a 100 percent response. The training will be provided to150,000 people systemwide over the next six months. The Regents will participate also.

Mr. Vining believed that the top down approach to the ethics of a corporation or university is critical. There must be a uniform understanding of what the University's standards and ethics are. Responses to matters that, as a result, are brought up through whistleblowers and others will help clarify what areas need further review. Over time, as new employees are required to take the ethics training, the program will be maintained.

The meeting adjourned at 1:20 p.m.

Attest:

Acting Secretary