The Regents of the University of California

COMMITTEE ON AUDIT
March 15, 2007

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

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

In attendance: Regents Dynes, Ledesma, and Preuss, Regent-designate Brewer, Faculty Representative Brown, Acting Secretary Shaw, General Counsel Robinson, Vice Presidents Broome, Foley, and Sakaki, Chancellors Birgeneau and Córdova, Acting Chancellor Blumenthal, University Auditor Reed, and Recording Secretary Bryan

The meeting convened at 8:00 a.m. with Committee Chair Ruiz presiding.

1. **INTERNAL AUDIT MID-YEAR REPORT**

University Auditor Reed reported that in terms of staff, the Auditor's Office is close to plan, but will be 3.5 FTE short by the end of the year. A large percentage of staff has left the University, which indicates the low level of market competitiveness of the University. In terms of time usage, time available is close to plan, and time distribution stands at 63 percent audit, 16 percent investigations, 15 percent advisory services, and a small percentage of audit support. Mr. Reed is troubled that investigations exceed advisory services, even by a small margin, because it is believed that advisory services are the most proactive of the services provided by the Auditor's Office, while investigations are the least proactive in that they take place only after a problem with a control has manifested. Guidelines for time distribution are 20 percent to 25 percent for advisory services, 10 percent to 15 percent for investigations, and approximately 60 percent for audits.

In terms of audits on a systemwide basis, the Auditor's Office issued the Soft Cost Audit, the Selected Policies Related to Ethics, and the Health Sciences Compliance Program. Systemwide audits have created useful and important findings for the University to address. In recent years there has been progress in terms of communication regarding the status of Management Corrective Actions (MCA). Mr. Reed stated that, of the 940 audit recommendations open as of December 31, 2006, the most critical and deserving of attention are 60 items that are designated as high risk and past the MCA due date. Mr. Reed will distribute the quarterly report to the Committee with a listing of those 60 items. Each item is the subject of a current plan to get corrective actions back on track. The number of such high risk and past due items rose to 60 from 36 when Mr. Reed reported last fall, and 19 are still open from that time of reporting. Mr. Reed was concerned that 12 of the 19 items are now past the projected resolved date.

Regarding investigations, Mr. Reed reported that the period began with 87 open investigations and closed with 88 investigations, with substantial churning. Through the hot line, the Auditor's Office received 81 original calls, 11 of which spawned an investigation. Most of the complaints were regarding human resource process issues. Significant investigations totaled 9 at the beginning of the period and 7 at the end of the period. Mr. Reed communicates significant investigations on a weekly basis to the Chair of the Committee on Audit, and on a quarterly basis to the Chairs of Audit, Finance, and the Board.

Plans for the remainder of the year include the completion of the audit plan. Executive compensation continues to be the most important systemwide audit activity in the Auditor's Office. A review has been completed on the senior leadership information system data that was used to create the Annual Report. An audit of the corrective actions that flow from last year's audits will continue until May, and will result in a task force report. Risk assessments and planning processes are under way, and Mr. Reed has solicited and received input regarding these efforts from a number of Regents, including most of the Committee chairs. Staff recruitment continues to be a significant challenge.

Good progress is being made on the development of a web-based process to track systemwide audit activities, including the establishment of the audit plan, the risk assessment process, the quarterly reporting to the Auditor's Office, the creation of the end report, and the audit tracking mechanism. This process will allow more seamless tracking of the whole audit tracking cycle, and should be completed in approximately one year.

The Auditor's Office has a process of internal peer review in which campus directors travel in teams of three or four to conduct a classic peer review of the audit program at each of the 12 locations. One internal peer review is done per quarter, taking three to four years to review the whole system. In 2008 the Auditor's Office will review the most recent cycle of peer reviews, retool the process, and begin the cycle again.

In terms of the Statement on Auditing Standard (SAS) 112, the Auditor's Office is in discussions with the controllers as to how they can help in their efforts with SAS 112 readiness. As key controls are identified that rely on the execution at the department level throughout the system, the auditors conducting departmental audits can ensure that controls exist and are documented in a manner sufficient for SAS 112 compliance at the department level.

An All Auditors Conference, which is a three-day conference convened every two years, was held during the period with all of the approximately 120 auditors throughout the system.

In response to a question from Committee Chair Ruiz, Mr. Reed stated that the time spent on investigations fluctuates from year to year. Investigation time levels have ranged from a low of approximately 10 percent to a high of 18 percent. The Auditor's Office prefers that this percentage be lower, given the amount of time required for an investigation, the urgency of investigations, and the interference investigations cause in the ability to carry out the regular plan in a smooth manner. Given the University's complexity, 10 percent to 12 percent is likely the lowest possible time percentage for investigations. Mr. Reed emphasized that though the Auditor's Office is spending more time than desired on investigations, such time spent is not out of step with the industry and does not indicate a negative University environment.

2. **AUDIT PLANNING RISK ASSESSMENT**

University Auditor Reed reported that the Auditor's Office is in the midst of the risk assessment process and has contacted the chair and vice chair of the Committee on Audit regarding this effort. He also solicited input from other members of the Committee to understand the Regents' concerns and what they would like to contribute to the Auditor's Office as next year's plan is formulated.

3. **THE ROLE OF THE GENERAL COUNSEL IN UC'S COMPLIANCE PROGRAM**

General Counsel Robinson reported that, in the wake of Sarbanes Oxley and the excesses during the early part of the decade, compliance programs are an expansive and expanding area. He stated that this discussion would be general, but that over time the General Counsel can report to the Committee on this issue in more detail.

Mr. Robinson stated that the General Counsel's Office has a substantial role to play with respect to the compliance activities of the University, including a role outside a formal compliance program. The lawyers in the Office of the General Counsel are considered standard-bearers for the organization. Behavior must be modeled for respect for the letter of the laws, regulations, and policies governing the institution, as well as for the spirit of those laws and policies. The standard-bearer position requires constant communication and engagement in the day to day activities of the organization in order to provide regular and timely counsel on compliance issues. This is not unique to lawyers, but rather something the Committee and The Regents should expect from all management within the organization.

With respect to a formal compliance program, the General Counsel is responsible for advising the Committee on Audit and The Regents concerning the legal requirements for an effective compliance program. Many of the requirements for such a program spring from the Department of Justice's federal sentencing guidelines. In the situation of a violation, organizations are treated differently by federal and State regulators depending on whether a formal compliance program is in place. Organizations with a compliance program tend to be treated more leniently because it is assumed that an effort has been made to inform employees of compliance obligations. Therefore, it is important to structure compliance programs that meet sentencing guidelines, among other concerns.

The General Counsel has a role in ensuring that a compliance program is properly designed. In order for a program to be effective, the governing authority, which is The Regents and in particular the Committee on Audit, must be knowledgeable of the content and operations of a compliance program, and that authority must exercise reasonable oversight over the program. The Board must be able to evaluate and make recommendations for modifications in light of ongoing organizational risk assessments. The Office of the General Counsel can play a role in advising the Committee and Board on legal risk, and Mr. Robinson expects to have a regular role in this effort. The General Counsel can and should be an active voice, along with the University Auditor and the Chief Compliance Officer, in clarifying and defining the legal regulatory and policy obligations of the organization. Examples of such obligations include Regental policy, health and safety laws, research contracts, reimbursement regulations in the health care industry, and environmental mandates. There are many models for designing a good and effective compliance program. For example, lawyers define the various legal obligations, compliance professionals establish the structures and processes to educate the employee and management population concerning those legal obligations, and enterprise risk management and internal auditors monitor and investigate compliance issues. Regardless of the model or models established at UC for a compliance program, the General Counsel expects that his Office would play a substantial role and be a substantial resource in clarifying the standards that need to be followed. At this point it is difficult to know what the standards are for UC; clarifying internal policies should also include the General Counsel's involvement.

A Deputy of Governance and Compliance will be added as staff in the Office of the General Counsel in order to assist the General Counsel directly and to provide support to The Regents, the Committee on Audit, and the University Auditor. This individual will also work closely with the corporate Secretary's Office as a type of legislative analyst in order to review consistently the policies that are being recommended for action by The Regents, provide an understanding of how those policies fit within the overall context of other existing policies, and ensure the intent of the policies are clear.

Mr. Robinson observed that it is a very small percentage of management and employees of an organization who are actively seeking to violate policy, law, or regulation. In the vast majority of cases, people want to comply with and be educated about compliance obligations. The true sign of an effective compliance program is not necessarily the number of detected violations but rather the number of avoided violations and a declining trend. When seeking a Chief Compliance Officer, it will be important to find someone who embodies those values and is able to communicate them to his or her direct reports and to the employee population. Mr. Robinson also believed that compliance is a management function, and that the best programs are those in which compliance is integrated into the day-to-day operations of management. The Committee may want to rethink whether it is appropriate for the Chief Compliance Officer to report directly to the Board, or if instead the individual should report directly to the President while still retaining access to the Board and reporting to it regularly. Mr. Robinson added that it is vitally important that resources be available to the compliance professionals, auditors, and to lawyers.

Regent Island asked for clarification regarding why the General Counsel believes that the Chief Compliance Officer should not be responsible directly to and under the supervision of the Board, given the Board’s constitutionally mandated requirements of oversight of the University and its affairs. Mr. Robinson reiterated that it is his belief that compliance is largely a management function and thus should be part of the day-to-day operations of the organization. Compliance should not appear to the employee population as an obligation separate from the management structure. Regent Island did not agree.

Committee Chair Ruiz stated that the position of the Chief Compliance Officer needs to be reviewed and possibly rethought with the Office of the President, given the difficulty in filling the position to date.

Expert Financial Advisor Vining stated his support for General Counsel Robinson’s position regarding compliance. He stated that compliance is not effective if it becomes a police action, and he fears that a compliance operation that is compelled to report violations and compliance to The Regents would become such a police action. He hoped that a culture could be developed within the University where compliance starts both at the top and the bottom, and where everyone feels it is part of his or her job and has it as an ongoing concern.

4. **APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2007**

The President recommended that the scope of the external audit of the University for the year ending June 30, 2007, including the expanded external audit coverage of the Lawrence Berkeley National Laboratory (LBNL) and Lawrence Livermore National Laboratory (LLNL), be approved.

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, expanded audit procedures at LBNL and LLNL, and the Federal Grants and Contracts (A-133) audits.

At the January 2006 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, 2006. The total cost of the audit for the fiscal year ending June 30, 2007 is $4,061,266, including out-of-pocket expenses, required audit scope changes for 2007, and a continuation of the expanded scope of work at LBNL and LLNL. Included in the total cost above is a $275,000 nonrecurring cost representing the upper end of the range of fees associated with Statement on Auditing Standard (SAS) 112 readiness.

Audit Scope Changes for Fiscal Year 2007

Scope changes for 2007 are required as a result of the University's intent to implement early new Governmental Accounting Standards Board (GASB) Statement No. 48, termination of the University's contract to directly manage the Los Alamos National Laboratory, application of certain audit procedures as discussed in the American Institute of Certified Public Accountants (AICPA) audit practice aid on alternative investments issued July 2006, the addition of UC Merced campus to a full-scope audit, inclusion of UCLA's "School as Lender" program in the A-133 audit, and consideration of AICPA SAS 112.

GASB Statement No. 48 requires the University to evaluate sales of receivables or future revenues in order to assess continuing involvement used to determine whether a true sale has occurred, or whether the substance of the transaction is a collateralized borrowing. The University is currently evaluating these past transactions previously approved by The Regents consisting primarily of the sales of Mortgage Origination Loans associated with the University's program.

The Los Alamos National Security, LLC (LANS) Board of Directors has retained its own independent auditors. Therefore, The Regents will not retain PwC to perform a separate audit of LANS. As a result, the fees for the University associated with the national laboratories have been reduced.

The AICPA issued an audit practice aid in July 2006 regarding the auditing of alternative investments. The focus of the audit procedures discussed in the practice aid is on assuring sufficient evidence is obtained to support the existence and valuation of non-readily marketable securities, such as private equity, real estate, and absolute return funds. As a result, additional procedures will be performed in relation to these assets.

The UC Merced campus to date has been subject to very limited audit procedures. The fiscal year 2007 audit will be the first year UC Merced will be subject to the same full scope audit procedures as all other campuses.

UCLA's law school has developed a "School as Lender" student loan program that is required to be audited under the federal A-133 audit requirements.

The AICPA's SAS 112 is in effect for FY 2007 and requires the auditor to evaluate UC's financial reporting control environment under a more rigorous and defined auditing standard.

Audit Scope at LBNL and LLNL

It was recommended that PwC perform "agreed-upon procedures" at LBNL and LLNL similar to the scope of work performed at these laboratories last year. The scope of the work would focus on the higher risk areas of each laboratory. The incremental fee for these recommended procedures is $258,195, including out-of-pocket expenses, and is included in the total cost of the audit discussed above.

Vice President Broome introduced UC's engagement partners, Ms. Murphy and Mr. Lipna, from PwC to highlight the plan. Ms. Murphy pointed out several aspects of the audit work to be done, including reviewing alternative investments in The Regents' portfolio such as hedge funds, private equities, and venture capital funds. At the November 2007 Regents' meeting, PwC will return to the Board with the results of the audit, including issuance on consolidated financial statements, retirement plan financial statements, internal control recommendations, and requirements that the profession mandates they make to the Committee on Audit. In February 2008, a report will be provided on the compliance with federal rewards.

Regent Schilling asked if there were a movement for standards regarding alternative investments. Ms. Murphy replied that the issue first surfaced in July 2005 from the AICPA regarding how auditors assess the fair value of alternative investments as reported on financial statements. A substantial reaction occurred in the auditing and investment world, following more explicit guidance from AICPA regarding how auditors approach these valuations. More clarity and standardization now exists regarding how the auditor addresses alternative investment valuations. Communication between auditors and general partners of investment funds is also improving.

Expert Financial Advisor Vining stated that control issues concerning SAS 112 will be conveyed to Ms. Broome, Ms. Murphy, Committee Chair Ruiz, and himself. Larger control issues will be conveyed to The Regents as soon as such issues become apparent to management and to the audit committee team.

The Committee recessed at 8:50 a.m.

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The Committee reconvened at 10:20 a.m. with Committee Chair Ruiz presiding.

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

In attendance: Regents De La Peña, Dynes, Hopkinson, Johnson, Kozberg, Lansing, Ledesma, Marcus, Moores, and Preuss, Regents-designate Allen, Brewer, and Bugay, Faculty Representative Brown, Acting Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, Provost Hume, Executive Vice President Darling, Vice Presidents Foley and Sakaki, Chancellors Birgeneau, Bishop, Córdova, Drake, Fox, Kang, Vanderhoef, and Yang, Acting Chancellor Blumenthal, and Recording Secretary Bryan

5. APPROVAL OF THE MINUTES OF THE PREVIOUS MEETING

Upon motion duly made and seconded, the minutes of the meeting of January 17, 2007 were approved.

6. APPROVAL OF EXTERNAL AUDIT PLAN FOR THE YEAR ENDING JUNE 30, 2007

The President recommended that the scope of the external audit of the University for the year ending June 30, 2007, including the expanded external audit coverage of the Lawrence Berkeley National Laboratory (LBNL) and Lawrence Livermore National Laboratory (LLNL), be approved.

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

The meeting adjourned at 10:25 a.m.

Attest:

Acting Secretary