



# The Regents of the University of California

## **Review of the Regents Committee on Audit Oversight Responsibilities and the Effectiveness of the University's Internal Audit Program**

**March 13, 2003**

# Background and Scope

Protiviti was engaged by the Regents Committee on Audit to support the Committee in its review of its oversight responsibilities and the effectiveness of the University's internal audit program. The assessment included five components as stated in the Scope of Services section of the Request for Proposal:

1. An evaluation of the Committee's objectives and purpose to be assured that they are clearly and appropriately defined.
2. An evaluation of the delegation of authorities, the communication channels and reporting relationships to determine that they a) provide the opportunity for the appropriate level of oversight by The Regents; and b) foster the independent, unbiased, levels of communication necessary to assure the policies of the University are upheld.
3. A review of the procedures, processes and organizational structure that assure the independence of all the various elements that comprise the internal audit function.
4. A review of the practices, policies and procedures for reporting audit findings and conclusions in comparison to professional standards and best practices, again with a view towards assuring independence and objectivity.
5. A review of the Committee's responsibilities in view of the newly enacted Sarbanes-Oxley Act of 2002.

During the past 60 days, Protiviti has executed a work plan designed to accomplish the scope outlined on the previous page. This work plan included the following elements:

- Review of critical documents including:
  - Regents Bylaws
  - Committee on Audit Meeting Minutes
  - Presentations to the Committee
  - Internal Audit Manual and other relevant internal policies and procedures
  - Internal Audit operating documents including minutes, performance reports and external reviews
- Conducted interviews with the following:
  - Members of the Committee on Audit
  - President and Senior Management at the Office of the President
  - University Auditor and Directors of Internal Audit at the campuses and labs
  - Senior management at the campuses and labs
- Compared current practices to professional standards and best practices

# Conclusions – Component 1

## Objective

An evaluation of the Committee's objectives and purpose to be assured that they are clearly and appropriately defined.

## Conclusions

There has been a dramatic evolution of the role of Audit Committee's over the last couple of years. With the enactment of the Sarbanes-Oxley Act of 2002, the change will continue. While the spotlight has been primarily on publicly traded companies, these reforms are being embraced by all organizations.

- The Committee's objectives and purpose need to be revised in order to clearly define its role in this changing environment. We have suggested a charter for your consideration.
- Financial expertise needs to be available to the Committee in order for it to effectively meet its objectives. This could be achieved through the use of an Advisory Committee or consultant.
- Orientation and continuing education needs to be considered as a way to enhance the Committee's knowledge.
- Continuity of Committee leadership needs to be strengthened (minimum of two years). This would enhance the effectiveness of the Committee.

## Current Bylaw

The current Bylaw for the Committee's does not clearly define its responsibilities. Audit Committee practices have evolved over the years to clearly define the role and responsibilities in an Audit Committee Charter.

### **12.1 Committee on Audit.**

The Committee on Audit shall:

- a. Exercise supervision over post-auditing activities related to the conduct and administration of the University.
- b. Transmit to the President of the University, subject to the prior approval of the Board, such instructions as it deems necessary for the enforcement of sound accounting and auditing practices.
- c. Recommend to the Board a firm of independent certified public accountants which shall audit the financial statements of the Corporation and of the University on an annual basis in accordance with generally accepted auditing standards and make such studies as shall be authorized by the Committee for the information of the Board.
- d. Act in an advisory capacity to the President of the University with respect to appointment of the University Auditor.

## Suggested Bylaw or Charter

### 12.1 Charter, Committee on Audit

- a. The Committee on Audit shall advise the Board of Regents in connection the Board's responsibilities relating to the quality and integrity of the Corporation and University's financial reporting, compliance with legal and regulatory requirements, systems of internal control and risk mitigation, independent certified public accountant's qualification and independence and the performance of internal audit and the independent certified public accountant.
- b. The Committee shall have not less than five (5) members.
- c. The Committee shall meet at least four times a year.

## Suggested Bylaw or Charter (cont.)

d. The Committee shall:

1. Monitor the University's system of internal control and the adequacy of accounting, financial and operational policies and practices on financial and significant compliance reporting.
2. Review the annual internal audit plan and discuss the extent that it addresses high risk areas with the University Auditor and management.
3. Review the annual report on the accomplishments of the internal audit department and discuss significant issues of internal control and compliance with the University Auditor and management.
4. Discuss the planned scope of the annual audit and other engagements with the independent certified public accountant and review the results of the audit and other engagements with the independent certified public accountant and management.
5. Receive and review the annual financial report with the independent certified public accountant and management.
6. After considering the recommendations of management, recommend to the Board the certified public accountant to serve as independent auditor and pre-approve any services provided by the certified public accountant.
7. Confer with the President of the University prior to the appointment, reassignment or replacement of the University Auditor.
8. Have the power, through its Chair, to call special meetings of the Committee and to request management to address specific issues within the mandate of the Committee and have the authority to engage independent counsel and other advisors to carry out its duties.

# Audit Committee Financial Expert

Audit Committee member competency has been a focus of public company reform in the last couple of years. Audit Committees have gravitated towards membership that includes those familiar with financial reporting and internal controls. Most companies are designating at least one member (preferably the Committee Chair) as the audit committee financial expert. The SEC has defined this expert as a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements.
- Ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves.
- Experience preparing, auditing, analyzing or evaluating financial statements or in actively supervising people engaged in such activity.
- An understanding of internal controls and procedures for financial reporting.
- An understanding in audit committee functions.

A person must have acquired these attributes through any one of the following:

- Education and experience as a financial or accounting officer or public accountant or auditor.
- Experience actively supervising a financial or accounting officer or public accountant or auditor.
- Experience overseeing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements.
- Other relevant experience.

# Audit Committee Financial Expert (cont.)

Given the unique governance structure of the Board of Regents, whereby membership is attained through appointment by the Governor or as a function of the political office or position held, the Board cannot always assure that an individual on the Committee meets the qualifications of an audit committee financial expert. In order to address this potential gap, we recommend that the Board consider one of two alternatives in order to gain access to this expertise:

- Form a committee of independent advisors who meet the audit committee financial expert criteria. This would be similar to the Board's Investment Advisory Committee. This committee would attend the Committee on Audit's meetings and act to advise the Committee as it discharges its responsibilities. This committee could consist of two or three advisors who would serve a three to five year term. This would help improve the continuity of the Committee over time.
- Hire an independent consultant who meets the audit committee financial expert criteria. The consultant would attend the Committee meetings and act to advise the Committee as it discharges its responsibilities. The consultant could also be responsible for providing the Committee members with an orientation and continuing education.

# Conclusions – Component 2

## Objective

An evaluation of the delegation of authorities, the communication channels and reporting relationships to determine that they a) provide the opportunity for the appropriate level of oversight by The Regents; and b) foster the independent, unbiased, levels of communication necessary to assure the policies of the University are upheld.

## Conclusions

- As the importance of the duties of audit committees increase, so does the level of oversight of accounting and financial reporting as well as various other regulatory and audit matters. The suggested charter will cause the Committee on Audit to increase its oversight.
- Management, the external auditor and the University Auditor have historically presented information in line with the suggested charter, however, the time by the Committee devoted to the information has not always allowed the Committee to be well informed about financial operations and reporting, internal control systems, compliance and related matters. While we have seen this change over the past year, meetings should be structured to devote the time necessary for the Committee to ask the questions necessary for adequate oversight.
- The Chair of the Committee is pivotal to proper oversight. Best practices have the Chair engaged in discussions with management, the external auditor and the University Auditor as issues evolve and setting the meeting agenda to devote adequate time for education and dialogue on key issues. Historically, this involvement has varied. An active level of involvement will foster a greater level of independent and unbiased communication.

## Conclusions (cont.)

- The historical meeting structure may tend to inhibit independent and unbiased levels of communication. This is a sensitive issue with a governmental entity subject to open meeting laws. Best practice recommendations include executive sessions by the Committee separately with the external auditor, University Auditor and management. Typically these executive sessions cover potential independence issues such as difficulties that the external auditor or University Auditor encountered in the course of their work, including restrictions on their scope or access to information or significant disagreements with management. The Committee has held executive sessions in the past with the external auditor. Similar executive sessions should be held with the University Auditor and management.
- The Committee historically has not dealt with the results of the other audits performed by the external auditor during their meetings. This includes the A-133 audit of the Federal financial assistance programs, NCAA audit, bond program audits and hospital audits. The Committee should routinely hear the scope and results of these engagements as a part of their oversight.

# Conclusions – Component 3

## Objective

A review of the procedures, processes and organizational structure that assure the independence of all the various elements that comprise the internal audit function.

## Conclusions

- The dual reporting organizational structure currently in place with internal auditors based at the campus/lab provides for greater involvement of internal audit and generally provides for independence on the part of the internal audit professionals.
- The Internal Audit Manual (Manual) clearly describes the professional's responsibilities for reporting the results of their work while maintaining their independence.
- The new Whistleblower Policy has created a stronger independent structure to deal with investigations. The Locally Designated Officer has responsibility for management of reported events while conferring with the Investigations Workgroup.
- In order to enhance independence, the University Auditor should take full responsibility for certain responsibilities as outlined on page 14 that are currently shared with the campus/lab management.
- A standard local audit committee charter should be considered in order to provide greater consistency among the committees at the campuses/labs.
- Local audit committee meetings are not always held as provided for in the Manual (at least 3 times per year) and attendance by members of management can vary based on perception of importance. This needs to be monitored by the University Auditor and addressed with the campuses/labs.

## Conclusions (continued)

- Certain sensitive investigations should be performed by the University Auditor or an outside consultant if independence of the campus/lab auditor could be impaired. This is a highly judgmental area which requires consultation with the University Auditor.
- The Manual provides conflicting descriptions of the Advisory Services that internal audit can provide management. This can cause the auditor to perform services that could impair their independence (i.e. control design). A clearer definition of the services that are allowable needs to be communicated. The University Auditor also needs to monitor the types of projects performed in order to assure that they are appropriate as advisory services where the reporting is less formalized.
- The Investigative Services provided at the campus/lab are monitored by the University Auditor on an ad hoc basis. This does not provide adequate oversight in monitoring the timely completion of the investigations or provide the ability to monitor trends that may be indicative of independence issues. Development of a case management tool would allow the University Auditor to better monitor this area.
- The University Auditor should meet annually with the Chancellor/Lab Director to review the conduct of the audit plan.
- The Manual currently does not require that the University Auditor receive annually a signed statement of compliance with professional standards from all auditors. Some campuses are doing this. This practice should be incorporated into the policy.







## Defined Services

By way of background, the following are the defined services of internal audit from the Manual with an approximate level of effort based on the 2002 audit results.

		<u>Approximate Level of Effort</u>
Audit	Planned and supplemental program of regular audits of business units and business processes that cut across organizational units.	65%
Investigations	Investigations into suspected financial irregularities whether reported by whistleblowers, uncovered in the course of regular audits, or based upon concerns conveyed by management.	15%
Advisory Services	Broad array of activities beyond regular audits. <ul style="list-style-type: none"> <li>- Internal control and accountability</li> <li>- Special projects and consultation</li> <li>- Systems development and reengineering</li> </ul>	20%

# Dual Reporting Responsibilities

## Current Dual Reporting Responsibilities

	<u>Campus/Lab</u>	<u>University Auditor</u>	<u>Shared</u>
Administration (space and funding)	X		
Professional and technical aspects		X	
Approval of the audit plan			X
Evaluation of the internal audit program			X
Selection of the Internal Audit Director (IAD)			X
Annual performance evaluation of the IAD			X
Determination of the compensation of the IAD			X
Assess the adequacy of the resources			X
Agreement on termination of the IAD			X
Approval of changes to the audit plan			X

In order to enhance independence, the duties indicated by the arrows should move to the responsibility of the University Auditor. Input from the Campus/Lab management should be sought in the execution of these duties.

# Conclusions – Component 4

## Objective

A review of the practices, policies and procedures for reporting audit findings and conclusions in comparison to professional standards and best practices, again with a view towards assuring independence and objectivity.

## Conclusions

- Internal Audit maintains a formal process for communicating to management and the the Regents the results and recommendations for all audits conducted.
- Audit report drafts are reviewed with the operating management responsible for the audited activity. This is done to confirm the factual accuracy of the findings and is a practice endorsed by professional standards.
- The Manual provides policies to the professionals for resolving disputes with auditees. It clearly states that the professional judgment of the internal auditors cannot be overridden or unduly influenced by audit clients. It further states that the judgment of the campus/lab Internal Audit Director is final and cannot be appealed to the University Auditor or senior management.
- The Manual needs to more clearly describe the procedures to be used in reviewing drafts of investigative reports. It states that procedures similar to those used for the review of audit reports should be utilized. Given the potential sensitivity of the subject matter of the investigation and the results, a more guarded approach should be considered.

# Sabanes-Oxley Recommendations

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Audit Committee Purpose</b></p>	<p>Audit committee charter must address the Purpose of the Audit Committee, which at minimum must be to assist the board of directors in the oversight of the:</p> <ul style="list-style-type: none"> <li>• Integrity of financial statements</li> <li>• Company's compliance with legal and regulatory requirements</li> <li>• Independent auditor's qualifications and independence</li> <li>• Performance of Company's internal audit function and independent auditors</li> </ul> <p>The audit committee must also prepare the report required by SEC rules to be included in annual proxy statement (report to shareholders).</p>			<p><u>Audit Committee Defined (Sec. 205)</u></p> <p>A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing:</p> <ul style="list-style-type: none"> <li>• The accounting and financial reporting processes of the issuer; and</li> <li>• Audits of the financial statements of the issuer.</li> </ul> <p>If no such committee exists, the entire board of directors will be considered the audit committee.</p>	<p>Regents currently have a Committee. The recommended charter will incorporate this purpose.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rule	NASDAQ Proposed Rule	Amex Proposed Rule	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Independence of Board and Audit Committee Members</b></p>	<p>Independent directors must constitute a majority of board of directors.</p> <p>Regularly scheduled executive sessions of non-management directors required.</p> <p>No director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company. Companies must disclose these determinations.</p> <p>More stringent definition of “independence” for audit committee membership than other independent board members.</p> <ul style="list-style-type: none"> <li>• Director fees must be the sole compensation from the company in order for directors to qualify to serve on the audit committee.</li> <li>• Concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into contracts with a director.</li> </ul> <p>In order to be considered independent, a former employee must have ended his or her relationship with the Company 5 years before.</p> <p>No director who is, or in the past 5 years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be “independent” until 5 years after the end of either the affiliation or the auditing relationship.</p>	<p>Independent directors must constitute majority of Board. Executive sessions of independent directors required.</p> <p>Prohibits independent directors or non-employee family members from receiving payments in excess of \$60,000 other than for board service.</p> <ul style="list-style-type: none"> <li>• Prohibits audit committee members from receiving any payment other than payment for board or committee service.</li> <li>• Prohibits a director from being considered independent if the company makes payments to an entity (including a not-for-profit organization) where the director is an executive officer and such payments exceed the greater of \$200,000 or 5% of the recipient’s gross revenues.</li> </ul> <p>Former partners or employees of the outside auditors who worked on a company’s audit engagement are not deemed independent. A three-year “cooling off” period would be applied to directors who are not independent due to having worked on the company’s audit engagement.</p> <p>Affiliated persons may not serve as an audit committee member. Audit committee members may not own or control 20% or more of the issuer’s voting securities, or such lower number as may be established by the SEC under Section 301 of the Sarbanes- Oxley Act.</p>	<p>Amex-listed companies must have boards comprised of a majority of independent directors, except for “controlled” companies and small business filers.</p> <p>Board meetings must be held on at least a quarterly basis. Independent directors must meet as often as necessary to fulfill their responsibilities, including in executive session without the presence of non-independent directors and management at least annually.</p> <p>The definition of “independent” will be tightened and the board of each listed company will be required to evaluate any relationship between a director and the company and make an affirmative determination that such relationship does not preclude a determination that the director is independent. Audit committee members will only be permitted to receive such fees from the listed company as permitted by SEC rules pursuant to the Sarbanes Act.</p> <p>Boards of Amex-listed companies may not be classified into more than three classes of directors, and each director’s term of office may not exceed three years.</p>	<p>Establishes independence definition for audit committee members (Sec. 301).</p> <p>“Independent” is defined as not receiving, other than for service on the board, any consulting, advisory or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.</p> <p>The SEC may make exemptions for certain individuals on a case-by-case basis.</p>	<p>None of the current Committee on Audit members is paid a salary or other compensation by the University per Bylaw 8.1. It is unclear as to the Regent’s policies on whether employers of the members of the Committee can have substantial business with the University or whether spouses or dependents of the members can be employed by the University.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Qualifications of Audit Committee Members</b></p>	<p>The NYSE will wait until the SEC interprets “financial expert ” before issuing any modifications to existing requirements.</p>	<p>Requires that in selecting the audit committee’s financial expert issuers consider whether a person has sufficient financial expertise in the accounting and auditing areas specified in the Sarbanes-Oxley Act, through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of an issuer or from a position involving the performance of similar functions.</p> <p>Requires that all audit committee members be able to read and understand financial statements at the time of their appointment rather than “within a reasonable period of time” thereafter (as indicated in the existing listing standards).</p> <p>Eliminates exceptions in existing listing standards for the audit committee requirements for Small Business issuers.</p>	<p>Audit committee requirements will be conformed to provisions and requirements of the Sarbanes-Oxley Act.</p> <p>Audit committee chairs of Amex-listed companies must be financially sophisticated and all members of the audit committee must be financially literate at the time of appointment.</p> <p>Audit committee and board composition requirements applicable to Small Business filers will be increased (in comparison to existing Amex requirements for such entities).</p>	<p>SEC to require disclosure of whether the audit committee has at least one financial expert. If an audit committee does not have a financial expert the reason why must be disclosed (Sec. 407).</p> <p>The SEC defined an audit committee financial expert as a person with the following attributes:</p> <ul style="list-style-type: none"> <li>• Understanding of GAAP and financial statements</li> <li>• The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves.</li> <li>• Experience in preparing, auditing, analyzing or evaluating financial statements of similar issuers or experience actively supervising people engaged in such activities.</li> <li>• An understanding of internal controls and procedures for financial reporting.</li> <li>• An understanding of Audit Committee functions</li> </ul>	<p>This is an area where the structure of the selection of the Regents may not always assure that an audit committee financial expert who meets these requirements exists. We have recommended the creation of an advisory committee or retention of a consultant who posses these skills in order to provide the Committee the necessary skills.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committee Service Restrictions</b>	<p>Service on more than three public company audit committees requires:</p> <ul style="list-style-type: none"> <li>Board determination that simultaneous service would not impair ability to effectively serve</li> <li>Disclosure of board determination in annual proxy statement</li> </ul>	<p>A <u>non-independent director</u> may serve on the audit committee pursuant to “exceptional and limited circumstances” for no more than two years, and is prohibited from serving as the chair of the audit committee. Directors not satisfying the audit committee independence requirements of the Sarbanes-Oxley Act are not eligible for this exception.</p>	<p>A non-independent director may serve on an Amex-listed company audit committee pursuant to the “exceptional and limited circumstances” exception for no more than two years, and such director may not serve as chair of the committee.</p>		<p>The concern of the stock exchanges is that audit committee members may not have time to effectively discharge their duties or that it may take time for members to become independent. As a volunteer Board, the Regents should not require this restriction.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Auditor Retention and Fees</b>	It is the duty of audit committee to retain and terminate the independent auditor ( subject, if applicable to shareholder ratification).	Audit committees have the sole authority to appoint, determine funding for, and oversee the outside auditors, as set forth in Section 202 of the Sarbanes- Oxley Act.	Amex-listed company audit committees must be responsible for selecting the independent auditor.	<p>Audit Committee is “directly responsible for the appointment, compensation and oversight” of the auditor (Sec. 202)</p> <ul style="list-style-type: none"> <li>• Including resolution of disagreements between management and the auditor regarding financial reporting</li> <li>• Auditor shall report directly to the audit committee</li> </ul>	The independent auditor is currently appointed by the Committee. Oversight is afforded at the Committee meetings as the auditor makes presentations on the scope and results of their work. The engagement letter with the auditor is currently with management and not the Committee. The Regents may want to consider having the engagement letter addressed to the Committee.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Pre-approval of Non-Audit Services and Prohibited Services</b></p>	<p>Audit committee must have sole authority to approve all significant non-audit engagements with the independent auditor.</p> <p>NYSE Commentary -In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management.</p>	<p>Audit committees must approve, in advance, all engagements of the independent auditor to provide permissible non-audit services, as set forth in Section 202 of the Sarbanes-Oxley Act.</p>		<p>Requires that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. In doing so, the audit committee is permitted to establish policies and procedures for pre-approval provided they are detailed as to the particular service and designed to safeguard the continued independence of the accountant. (Section 202)</p> <p>Requires disclosure to investors in periodic reports of approval of non-audit services (Sec. 202).</p> <p>Certain non-audit services are prohibited (Section 201):</p> <ul style="list-style-type: none"> <li>• Bookkeeping</li> <li>• Financial information systems design and implementation</li> <li>• Appraisal or Valuation</li> <li>• Actuarial</li> <li>• Internal audit outsourcing</li> <li>• Management functions</li> <li>• Broker/dealer, investment advisor or banking</li> <li>• Legal services</li> <li>• Expert opinions</li> </ul>	<p>It is important to point out that the GAO last year issued an amendment addressing auditor independence. This amendment, while not as specific as Section 202, did prohibit non-audit services by auditors in areas where they would be auditing.</p> <p>Many organizations are working with their audit committees to establish policies with respect to the types of non-audit services they will use the auditor for. They are also establishing the reporting to get pre-approval of the use of the services prior to engagement. In September 2002, the Committee passed a resolution implementing this concept. It prohibited services identified in SOA as prohibited, provided guidance on the types of non-audit services that are allowable and required pre-approval by the Committee.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Evaluation of External Auditor Qualifications and Independence</b>	<p>The audit committee will evaluate the qualifications, performance and independence of the external auditor.</p> <p>The audit committee will review a report by independent auditor describing</p> <ul style="list-style-type: none"> <li>• Internal quality control procedures</li> <li>• Material issues raised by most recent               <ul style="list-style-type: none"> <li>- internal quality-control or peer review</li> <li>- inquiry or investigation into audits by governmental or professional authorities in the last 5 years</li> <li>- steps taken by firm to deal with such issues</li> </ul> </li> </ul> <p>Evaluate independent auditor's qualifications, performance and independence</p> <ul style="list-style-type: none"> <li>• Including all relationships between independent auditor and company</li> <li>• Review should include evaluation of "lead partner"               <ul style="list-style-type: none"> <li>- input from management,</li> <li>- input from internal audit</li> </ul> </li> </ul> <p>Audit committee should present its conclusions with respect to the qualifications, performance and independence of the independent auditor to the full board of directors.</p>			<p>Five-year rotation required for the "lead" and "reviewing" audit partner with a five-year time out period (Sec. 203).</p>	<p>Committee should consider establishing partner rotation policies and having an annual evaluation of the qualifications, performance and independence of the external auditors. This should be done with management input on the potential impact.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>External Auditor Communication and Resolution of Disagreements by the Audit Committee</b>	Review with independent auditor any audit problems or difficulties and management's response <ul style="list-style-type: none"> <li>• Accounting adjustments noted or proposed but passed (as immaterial or otherwise)</li> <li>• National office consultations</li> <li>• "Management" or "internal control" letter issued</li> </ul> Review with the external auditor the responsibilities, budget and staffing of internal audit function.			The Sarbanes-Oxley Act requires that the audit committee be responsible for resolution of disagreements between management and the auditor regarding financial reporting (Sec. 301).	If a disagreement is not resolved, audit committees may want to involve internal or external counsel to help determine a course of action that may include seeking third-party advice concerning the unresolved issue.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Hiring of Auditor Personnel</b>	Audit committee to set clear hiring policies for employees or former employees of independent auditors. Hiring policies should take into account conscious or subconscious pressures that may exist. NYSE noted that these individuals are often valuable additions to management.			Unlawful for registered public accounting firm to perform an audit if the company's CEO, CFO, CAO, Controller (or equivalent) was employed by the audit firm and participated in the company's audit during the 1- year period preceding the date of initiation of the current audit (Sec. 206).	Some companies have established a two-tiered policy – one that prohibits the hiring of auditor personnel for the selected senior positions and another related to lesser positions within the company. The Committee may want to consider adopting a policy after consideration of the potential impact with management.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Certification of Financial Information by CEO/CFO</b></p>	<p>CEO certification to NYSE indicating there has been no violation of NYSE listing requirements.</p>			<p>CEO and CFO must certify annual and quarterly reports stating that the financial reports have been reviewed and based on the officer's knowledge contain no untrue statement or omission of material fact and fairly present the Company's financial condition, results of operations and cash flows (Sec. 302 and 906).</p> <p>Signing officers are responsible for establishing and maintaining internal controls (this term was clarified to be "disclosure controls and procedures" in the final SEC release), and must have evaluated the effectiveness of these controls within 90 days prior to the filing date and have presented in the report their conclusions about the effectiveness of these controls (Sec. 302).</p> <p>Signing officers have disclosed to auditors and audit committee (Sec. 302)</p> <ul style="list-style-type: none"> <li>- All significant deficiencies in design or operation of internal controls which could adversely affect ability to record, process, summarize and report financial data</li> <li>- Any material weaknesses in internal controls</li> <li>- Any fraud, whether or not material, that involves management or other employees with significant role in internal controls</li> </ul> <p>Signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation.</p>	<p>We are not aware of any college or university that requires these certifications. We have seen instances where there has been a statement included in the annual financial reports of management's responsibility for the completeness and accuracy of the report as well as for the underlying system of internal controls. We have also seen where decentralized organizations have created internal certifications and procedures to heighten the importance of certain reporting requirements.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Assessment of Internal Controls</b>	Audit committee must review major issues as to adequacy of company's internal controls and any special audit steps adopted in light of material control deficiencies.			Annual report must contain a report on internal controls which shall (Sec. 404) <ul style="list-style-type: none"> <li>• State managements' responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting</li> <li>• Contain an assessment of the effectiveness of internal controls related to financial reporting</li> <li>• Include the independent auditor's attestation report on management's assertion as part of the audit</li> </ul>	<p>We are not aware of any college or university that requires these reports. We certainly are seeing a new emphasis on the importance of maintaining an adequate internal control structure. We have also seen instances where there has been a statement included in the annual financial reports of management's responsibility for the completeness and accuracy of the report as well as for the underlying system of internal controls.</p> <p>Attaining the independent auditor's attestation report would likely be an expensive undertaking for an organization as large and decentralized as the University.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committees Review of Accounting and Related Issues</b>	<p>Audit committee must review</p> <ul style="list-style-type: none"> <li>• Major issues regarding accounting principles and financial statement presentations, including any significant changes in company's selection or application of accounting principles</li> <li>• Major issues as to adequacy of company's internal controls and any special audit steps adopted in light of material control deficiencies</li> <li>• Analyses prepared by management and/or independent auditor setting forth               <ul style="list-style-type: none"> <li>- Significant financial reporting issues and judgments</li> <li>- Effects of alternative GAAP methods on the financial statements</li> </ul> </li> <li>• The effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements</li> <li>• Earnings press releases (paying particular attention to any use of "pro forma" or "adjusted" non GAAP information) as well as the financial information and earnings guidance provided to analysts and rating agencies.</li> </ul>	<p>Audit committee or a comparable body of the board of directors will be required to review and approve all related-party transactions.</p>	<p>All related party transactions entered into by Amex-listed companies must be subject to oversight by the audit committee.</p>	<p>Auditor reports on a timely basis to the Audit Committee (Sec. 204)</p> <ul style="list-style-type: none"> <li>• All critical accounting policies and practices in use by issuer</li> <li>• GAAP alternatives discussed with management and the alternative preferred by the audit firm</li> <li>• Other material written communications with management such as the management letter and unadjusted audit differences</li> </ul> <p>Companies disclose all material off-balance sheet transactions and other relationships that may have a material effect (Sec. 401).</p> <p>Companies are required to make "Real Time" disclosure of material changes in financial condition required (Sec. 409).</p>	<p>Many of these communications currently are being made as required by professional standards. With the University's bond indenture requirements to make certain timely disclosures, it may make sense for management to assess the adequacy of the disclosure controls and procedures.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committees Discussion of Financial Reporting and Other Information</b>	<p>Discuss annual and quarterly financial statements, including MD&amp;A with management and independent auditor</p> <p>Discuss earnings press releases</p> <p>Discuss financial information and guidance provided to analysts and rating agencies</p> <p>Discuss risk assessment and risk management policies set by management.</p> <p>NYSE rules require discussion of only general information related to press releases and analyst guidance.</p>				<p>Some of this does not apply to the University. Our recommended charter should address this. Discussion of risk assessment and management of the risks should be a topic of discussion at one of the audit committee meetings.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Whistleblower Communication Process</b>		Audit committees will be required to establish procedures for the receipt, retention and treatment of complaints received by the issuer and ensure that such complaints are treated confidentially and anonymously, as set forth in Section 301 of the Sarbanes- Oxley Act.		Audit Committees will establish procedures for (Sec. 301) <ul style="list-style-type: none"> <li>• Receipt, retention and treatment of complaints received by the Company concerning accounting, internal controls or auditing matters</li> <li>• Confidential submissions by employees of concerns regarding questionable accounting or auditing matters</li> </ul>	The University currently has a broader policy in place. This process should be monitored by the Committee and periodically reported on.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committee Meetings and Executive Sessions</b>	Meet separately on a periodic basis with management, internal auditors and the independent auditors.		<p>Audit committees must meet on at least a quarterly basis.</p> <p>Audit committees must meet privately with the independent auditor.</p>		The Committee should meet at least quarterly. Executive sessions should be considered with General Counsel in light of the open meetings laws.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Internal Audit Requirement</b>	<p>Each NYSE-listed company must have an internal audit function.</p> <p>NYSE Commentary-This requirement does not necessarily mean that a company must establish a separate internal audit department or dedicate employees to the task on a full-time basis; it is enough for a company to have in place an appropriate control process for reviewing and approving its internal transactions and accounting. A company may choose to outsource this function to a firm other than its independent auditor.</p>				<p>The University has an existing function and is monitored by the Committee.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Use of Advisors by the Audit Committee</b>	Audit Committee shall have authority and funding to engage independent counsel and outside advisors as appropriate without seeking approval of the board of directors.	Audit committees have the authority to engage and determine funding for independent counsel and other advisors, as set forth in Section 301 of the Sarbanes-Oxley Act.	Audit committees have the authority and funding to engage independent counsel and other advisors in appropriate circumstances.	Requires that audit committees have the authority to consult with and retain legal, accounting and other “experts” in appropriate circumstances (Sec. 301).	This is included in the recommended charter.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committee Evaluation</b>	Annual performance evaluation of audit committee required.				This may be considered as more guidance is issued.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Audit Committee Communication with Board of Directors</b>	<p>Report regularly to the board of directors any issues concerning</p> <ul style="list-style-type: none"> <li>• Quality and integrity of financial statements</li> <li>• Compliance with legal or regulatory requirements</li> <li>• Performance and independence of independent auditor</li> <li>• Performance of internal audit function</li> </ul> <p>Audit committee should present its conclusions with respect to the qualifications, performance and independence of the independent auditor to the full board.</p>				<p>The Committee currently reports to the Board. Future reports should report the results of the duties defined in the recommended charter.</p>

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<b>Continuing Education for Board Members</b>	The Company's Corporate Governance Guidelines must address director orientation and continuing education.	Continuing education for all directors will be required, pursuant to rules to be developed by the NASDAQ Listing and Hearing Review Council and approved by the NASDAQ Board.			We expect that more companies will deliver tailored, company specific training at the board and committee level. The Committee may want to consider this.

# Sabanes-Oxley Recommendations (cont.)

TOPIC	NYSE Proposed Rules	NASDAQ Proposed Rules	Amex Proposed Rules	Sarbanes – Oxley Act of 2002 And SEC Rules	Observations
<p><b>Code of Business Conduct and Ethics</b></p>	<p>Companies must adopt and disclose</p> <ul style="list-style-type: none"> <li>• Corporate Governance Guidelines</li> <li>• Code of Business Conduct and Ethics</li> </ul> <p>Company Web site must include charters of committees, governance guidelines and code of ethics.</p>	<p>Require all companies to have a code of conduct addressing, at a minimum, conflicts of interest and compliance with applicable laws, rules and regulations, with an appropriate compliance mechanism and disclosure of any waivers to executive officers and directors. Waivers can only be granted by independent directors. The code of conduct must be publicly available.</p>	<p>Each Amex-listed company must adopt and disclose a code of ethics and compliance program.</p>	<p>Code of Ethics for Senior Financial Officers (Sec. 406)</p> <p>Each issuer to disclose:</p> <ul style="list-style-type: none"> <li>• In its periodic reports—whether it has adopted a code of ethics for its senior financial officers (and if not, why not)</li> <li>• In a Form 8-K or in “dissemination by the Internet”—any change in, or waiver of, the code of ethics.</li> </ul> <p>The SEC issued proposed rules regarding Section 406 of the Act on October 22, 2002. Final rules are required to be issued on or before January 26, 2003.</p>	<p>Although neither the Act nor the stock exchanges specify where in the corporate governance structure this issue should fall, many boards of directors have delegated the oversight of the code of business conduct and ethics to the audit committee.</p> <p>The University currently does not have an overall code of conduct and should consider adopting one. Compliance with the policy should then be monitored and reported on to the Regents.</p>