



**REPORT TO THE REGENTS'
COMMITTEE ON AUDIT**

SARBANES-OXLEY CONSIDERATIONS

September, 2003
Office of the University Auditor
Office of the President
University of California

	UNIVERSITY OF CALIFORNIA REGENTS AUDIT COMMITTEE SARBANES-OXLEY CONSIDERATIONS			
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Audit Committee Purpose	<p>Audit Committee Defined (Sec. 205)</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"> • The accounting and financial reporting processes of the issuer; and • Audits of the financial statements of the issuer. <p>If no such committee exists, the entire board of directors will be considered the audit committee.</p>	Regents currently have a Committee. The recommended charter will incorporate this purpose.	NACUBO endorses the SOA audit committee recommendations. Large institutions have mostly had audit committees and those without separate committees are forming them. SOA considered “best practice” for audit committees. Institutions without audit committees are encouraged to assign the functions to another committee, e.g. finance.	The Audit Committee plans to adopt a revised Charter incorporating recommendations of Protiviti regarding objectives and purpose of the Audit Committee.

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Independence of Board and Audit Committee Members	<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 Audit Committee can have substantial business with the University or whether the University can employ spouses or dependents of the members.</p>	<p>Independence of audit committee members should be considered.</p> <p>Conflicts of interest should be considered.</p>	<p>As noted, members of the Audit Committee do not receive a salary or other compensation.</p> <p>The Audit Committee will clarify with The Office of General Counsel the following:</p> <ul style="list-style-type: none"> • Employers of the members doing substantial business with the University • Employment of the member’s spouse and/or dependents.

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Qualifications of Audit Committee Members	<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"> • Understanding of GAAP and financial statements • The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves. • Experience in preparing, auditing, analyzing or evaluating financial statements of similar issuers or experience actively supervising people engaged in such activities. • An understanding of internal controls and procedures for financial reporting. • An understanding of Audit Committee functions 	<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 Audit Committee the necessary skills.</p>	<p>This is a substantive issue for higher education especially for public institutions where the board is appointed by alumni or elected officials. Training and retention of financially astute audit committee members will also be important. President, Chancellor or governor may need to be advised on this recruiting need.</p>	<p>The Audit Committee should consider identifying an advisor with the prescribed knowledge base and experience to provide broad technical advice to the Audit Committee.</p>

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Audit Committee Service Restrictions	This comment in the Protiviti report stems from rules of the stock exchanges (rather than SOA) regarding service on multiple companies' audit committees and limitations of service by non-independent directors.	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.	N/A	N/A

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Auditor Retention and Fees	<p>Audit Committee is “directly responsible for the appointment, compensation and oversight” of the auditor (Sec. 202)</p> <ul style="list-style-type: none"> • Including resolution of disagreements between management and the auditor regarding financial reporting • Auditor shall report directly to the audit committee 	<p>The independent auditor is currently appointed by the Audit Committee. Oversight is afforded at the Audit 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 Audit Committee. The Regents may want to consider having the engagement letter addressed to the Audit Committee.</p>	<p>Audit Committee involvement is critical in the selection of auditors and the performance of the audit.</p>	<p>Currently, the engagement letter is signed by the Secretary of the Board on behalf of The Regents. We agree that the engagement letter should be addressed to the Audit Committee and executed by the Chair upon the recommendation of University management.</p>

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Pre-approval of Non-Audit Services and Prohibited Services	<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"> • Bookkeeping • Financial information systems design and implementation • Appraisal or Valuation • Actuarial • Internal audit outsourcing • Management functions • Broker/dealer, investment advisor or banking • Legal services • Expert opinions 	<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 Audit 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</p>	Higher Education should implement pre-approval for all non-audit services.	The September 2002 resolution fully addresses this aspect of SOA.

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Evaluation of External Auditor Qualifications and Independence	Five-year rotation required for the “lead” and “reviewing” audit partner with a five-year time out period (Sec. 203).	Audit 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.	Rotation of external audit partners is a challenging issue for HE due to the shortage of audit partners who are experienced in our industry. HE should work with their firms on this and consider a required rotation at least every five years.	UC management has conducted an informal evaluation of the performance of the external audit firm annually. The results of that informal evaluation will be shared with the Audit Committee in connection with the annual approval of audit fees in years already under contract. A more formal evaluation, engaging the Audit Committee in the process, will be performed in conjunction with the re-appointment of any firm when their initial term expires if the recommendation is to extend the firm's services. Audit partner rotation should be addressed in connection with any extension of audit services beyond the initial contract period--typically three years—with an expectation of rotation of the lead and reviewing partners after five years.
External Auditor Communication and Resolution of Disagreements by the Audit Committee	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.	Audit Committee oversight is critical to ensure the independence of the audit decisions.	Disagreements between the external auditors and management should be addressed to the Audit Committee for resolution. As necessary, the Audit Committee should seek internal or external counsel concerning the unresolved issue.

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Hiring of Auditor Personnel	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.	Higher Education should consider theoretical benefits compared to practical implications.	For an individual to be at a level where the underlying concern would apply, it is very probable that the position would require Regental approval due to the salary level. The related Regents Item should disclose the prior affiliation, and address any special independence concerns.

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Certification of Financial Information by CEO/CFO	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).	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.	Executive leaders should sign the external audit representation letter, including many of the required assertions. Some institutions are implementing "sub-certifications" from individual units or schools to the CEO and CFO, providing assurance on the underlying numbers and controls. Another alternative is periodic inquiries of key managers. Evaluate the clarity of your organization's policies for defining business unit responsibility for financial reporting. Ultimately the CFO must determine hi/her comfort level with the information being provided and may choose to increase the scrutiny and accountability for underlying results. Audit Committee should consider periodic inquiries of financial	The annual representation letter is signed by the President, SVP-Business & Finance and the VP Financial Management. Additionally, representation letters are signed by CEO's and CFO's in connection with the individual financial statements of the five medical centers. Campus Controllors also sign a representation letter tailored to the campuses. Management recommends expanding this procedure to include obtaining representations from campus Chancellors and Vice Chancellors for Financial Administration, as well as the three national laboratories' Directors and CFO's or equivalent. The attestation regarding evaluation of disclosure controls and procedures is much more involved. University management should assess evolving practices being employed within higher education and bring back to the Regents Audit Committee a recommendation for UC adoption that reflects "best practice" in the industry as those practices are developed.
	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).			
	Signing officers have disclosed to auditors and audit committee (Sec. 302) <ul style="list-style-type: none"> - All significant deficiencies in design or operation of internal controls which could adversely affect ability to record, process, summarize and report financial data - Any material weaknesses in internal controls - Any fraud, whether or not material, that involves management or other 			

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Assessment of Internal Controls	<p>Annual report must contain a report on internal controls which shall (Sec. 404)</p> <ul style="list-style-type: none"> State managements' responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting Contain an assessment of the effectiveness of internal controls related to financial reporting <p>Include the independent auditor's attestation report on management's assertion as part of the audit</p>	<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>	<p>This is one of the most substantive and controversial requirements of the act and goes well beyond standard audit practices. Although it is not currently required, there is a high certainly that this will be required in the future. Many organizations are reconsidering the adequacy of their control systems, and initiating multi-year efforts to evaluate and improve controls. The COSO model is considered the most widely accepted model for controls. Higher education institutions should prioritize key financial processes as a starting point. It will be important to monitor the action of peer institutions and regulatory requirements. This positive assertion on control would require a large sustained effort.</p> <p>The independent auditors attestation would require a separate arrangement that would be expensive</p>	<p>A statement in the annual report accepting management's responsibility for establishing and maintaining an adequate internal control structure and procedures will be incorporated in the annual report. The representation letters obtained from campus, lab and medical center management will include a statement of responsibilities for the systems of internal controls as well.</p> <p>The actions precedent to establishing a position from which to report on the assessment of the effectiveness of internal controls related to financial reporting requires discussion with internal and external auditors. Discussion is also needed with PricewaterhouseCoopers regarding the implications of their providing an attestation report on management's assertions.</p> <p>The University supports the concept of this element of SOA. As practices and plans in the private sector and higher education industry evolve, University management should assess evolving practices and bring back to the Regents Audit Committee a recommendation for UC adoption that reflects "best practice" in the industry.</p>

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Audit Committees Review of Accounting and Related Issues	<p>Auditor reports on a timely basis to the Audit Committee (Sec. 204)</p> <ul style="list-style-type: none"> • All critical accounting policies and practices in use by issuer • GAAP alternatives discussed with management and the alternative preferred by the audit firm • Other material written communications with management such as the management letter and unadjusted audit differences <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>	<p>Audit Committee oversight is critical to endure the independence of the audit function.</p>	<p>“Required communications” with the Audit Committee have been made in the past and should continue. In the new Audit Committee format, more time should be available for discussion of management letters and related communications.</p> <p>Management will review the disclosure requirements of bond indentures to ensure that the procedures include consideration of the matters that should be reported to the Board through the Audit Committee.</p>

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Audit Committees Discussion of Financial Reporting and Other Information	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements regarding the discussion of risk assessment (applicable) as well as earnings and analyst releases (not applicable).	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.	NACUBO silent on this aspect of SOA	The discussion of risk assessment and management of these risks should occur at the Audit Committee meeting(s) prior to the preparation of the annual audit plans by the external and internal auditors.
Whistleblower Communication Process	Audit Committees will establish procedures for (Sec. 301) <ul style="list-style-type: none"> • Receipt, retention and treatment of complaints received by the Company concerning accounting, internal controls or auditing matters • Confidential submissions by employees of concerns regarding questionable accounting or auditing matters 	The University currently has a broader policy in place. This process should be monitored by the Committee and periodically reported on.	A best practice consideration is establishing a hot line or confidential email channel for employees to report a range of allegations. Institutions can evaluate leveraging already existing confidential employee communication channels. The Audit Committee should consider reviewing the nature and disposition of reported matters.	The University's policies and procedures in this arena are robust. Still being developed, are improved reporting processes from campuses and labs to the Office of the President for the increased breadth of issues introduced by the 2003 policy. Reporting to the Audit Committee is under development. Currently, significant items are reported to the Audit Committee on an ad hoc basis. The revised reporting practices will give the Audit Committee a broader view of activity and dispositions.

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Audit Committee Meetings and Executive Sessions	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements.	The Committee should meet at least quarterly. Executive sessions should be considered with General Counsel in light of the open meetings laws.	N/A	The Audit Committee is scheduled to meet quarterly. An executive session has been held annually with the external auditors, but not with the University Auditor. However, the University auditor has direct access to and regular communications with the Chair of the Audit Committee.
Internal Audit Requirement	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements.	The University has an existing function and is monitored by the Audit Committee.	N/A	No recommendation
Use of Advisors by the Audit Committee	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.		This is part of the recommended charter.
Audit Committee Evaluation	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements.	This may be considered as more guidance is issued.	N/A	The NYSE requires an annual performance evaluation of the Audit Committee. There was no specific recommendation from Protiviti in this regard. Should the Audit Committee engage an independent advisor that individual would presumably be in a position to consult with the Audit Committee on opportunities to improve its performance.

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Audit Committee Communication with Board of Directors	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements.	The Audit Committee currently reports to the Board. Future reports should report the results of the duties defined in the recommended charter.	N/A	As the function of the Audit Committee evolves under its revised charter and SOA practices, additional reporting to the Board may need to be considered.
Continuing Education for Board Members	There was no SOA comment in the Protiviti report as these matters stem from stock exchange requirements.	We expect that more companies will deliver tailored, company specific training at the board and committee level. The Committee may want to consider this.	N/A	Management recommends that a portion of Audit Committee time be set aside for discussion of topics such as developments in corporate governance practices, internal control concepts, financial accounting and reporting developments and University systems and processes in such areas as compliance and controls.

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Code of Business Conduct and Ethics	<p>Code of Ethics for Senior Financial Officers (Sec. 406)</p> <p>Each issuer to disclose:</p> <ul style="list-style-type: none"> • In its periodic reports— whether it has adopted a code of ethics for its senior financial officers (and if not, why not) • In a Form 8-K or in “dissemination by the Internet”—any change in, or waiver of, the code of ethics. <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>	<p>The audit committee should review the existence and adequacy of the code of ethics and periodically review how compliance is assured.</p>	<p>The University has an Academic Code of Conduct for faculty. In addition, there is a code of conduct contained in the Health Sciences Systemwide Corporate Compliance Program applicable to health sciences personnel. Various segments of the University have professional code of ethics to which they ascribe by UC policy (for example Internal Auditors). However, there is no overarching code of ethics.</p> <p>Management will develop (with input from the Audit Committee) a systemwide code of ethics to be considered by the Audit Committee and Board and to be monitored and overseen under the jurisdiction of the Audit Committee on Audit.</p> <p>As a starting point, the SEC rules for a required code of ethics for senior management require that the code address:</p> <ul style="list-style-type: none"> • Honest and ethical conduct, • Full, fair, accurate and timely disclosures in filings with SEC, • Compliance with applicable laws, rules and regulations • Prompt reporting of code violations, and • Accountability for adherence to the code

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Additional SOA Matters Not Covered By Protiviti Report				
Rotation of Auditing Firms	The GAO will do a study on the potential effects of requiring the mandatory rotation of public accounting firms.	N/A	Current emphasis is on rotation of audit partners rather than rotation of firms. General sense is that mandatory rotation of audit firms is problematic given that only a few specialize in higher education, and that the rationale promoting mandatory rotation, i.e. improved independence, is weak under such circumstances.	The University's periodic competitive bidding practice coupled with other provisions re: partner rotation makes this less of a concern for UC than in the private sector. No action is warranted for UC at this time.
Inappropriate Influence of Auditors	It is unlawful for any officer or director of a company to take an action to fraudulently influence, coerce, manipulate or mislead an auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.	N/A	Should be addressed in the conduct/cod of ethics.	Agreed—should be covered in a code of ethics. The Audit committee may want to extend this concept to management influence on internal auditors in the course of their duties even though the impact would be unlikely to be material to the University's financial statements.

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Off-Balance Sheet Transactions	SEC shall study off-balance sheet disclosures to determine their extent and whether GAAP results in the financial statement issuers reflecting the economics of such transactions.		This may be a substantive issue for Higher Education. Periodic review and disclosure of off-balance sheet transactions should be considered.	In conjunction with their review of financial statements, the Audit Committee should annually engage financial management and the external auditors in discussion of off-balance sheet activity in the University.
Loans to Directors and Executive Officers	In general, it shall be unlawful for a company to extend personal loans to any director or executive officer.	N/A	Audit Committee should review for existence of and policy toward personal loans, especially housing assistance loans.	For the University, the Mortgage Origination Program and Supplemental Loan Program are relevant. These are programs established with the approval of The Regents.
Certain Financial Conflicts of Interest	Directors, officers and 10%+ owners must report designated equity security transactions by the end of the second business day following the day the transaction was executed.	N/A	Ownership of interests in related ventures or start-ups may be an issue in higher education.	All relevant University officials are subject to the California Fair Political Practices Act and its reporting requirements.