

Office of the President
January 10, 1996

TO MEMBERS OF THE COMMITTEE ON AUDIT:

ITEM FOR DISCUSSION

For Meeting of January 17, 1996

UPDATE ON IMPLEMENTATION OF COSO INTERNAL CONTROL-INTEGRATED FRAMEWORK

At the Special Meeting of the Committee on Audit on August 23, 1995, a recommendation was made for the accelerated adoption of a COSO (Committee of Sponsoring Organizations of the Treadway Commission)-based framework of internal controls.

The purpose of this item is to further the Committee's understanding of the COSO concepts and the suggested nature of a project to implement the recommendation. This discussion also will assist the Committee in its future review of a draft Request for Proposal for qualified big 6 accounting firms to assist with the project.

3. **REPORT ON IMPLEMENTATION OF COSO INTERNAL CONTROL-INTEGRATED FRAMEWORK, OFFICE OF THE PRESIDENT**

Auditor Reed recalled that at the August 23 meeting he reported that the Vice Chancellors for Business and Finance had accepted an Internal Audit recommendation to adopt COSO as the Internal Control-Integrated Framework for the University. COSO stands for the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting, better known as the Treadway Commission. The COSO report, published in 1992 after a five-year study, was designed to provide practical, broadly accepted criteria for establishing internal control and evaluating its effectiveness. Its principles and concepts deal exactly with the University's need at this moment to provide greater assurance to the Regents, the State Legislature, donors, and others regarding its fiscal accountability and stewardship responsibilities.

As reported on August 23, the COSO Internal Control Framework is broadly accepted across industry lines as the most comprehensive codification of internal control principles in existence. It is endorsed by the Association of College and University Auditors and is being implemented by numerous companies, including, in the bay area, Bank of America, Transamerica, PG&E, Pac Bell, and the Pacific Stock Exchange.

Mr. Reed explained that what is unique about COSO as opposed to more traditional views of internal controls is its broad view of the organization. Internal controls do not exist purely in the domain of the accountants and auditors. Everyone has a role in the control system, starting with the Board of Directors and the Audit Committee. While COSO includes adequate consideration of traditional control activities such as balancing, reconciling, segregation of duties, and dual authorizations, the broad organizational view focuses first on the control environment and the messages sent by the organization's leaders, referred to as the tone at the top. Mr. Reed pointed out that this is what is presently taking place at the University of California, with the Board of Regents expressing its concerns over the organization's control environment and taking ownership of the system of controls by making sure that management is addressing the control issues that confront the University. The Board's expectations are clear, and this message contributes importantly to management's ability to create a healthy control environment where accountability and an ethical business climate are the norms.

Mr. Reed reported that since the August 23 meeting, he has had extensive discussions with three of the big-six accounting firms and is in the process of scheduling meetings with two others. These firms have distinct national practices dealing with internal control issues, and they have experience helping large, complex organizations in a variety of industries, including higher education, to evaluate, establish, and implement processes for the continuous assessment and improvement of their systems of internal controls. Each of the firms concurs with the approach the Internal Audit has been promoting and the intent to adopt an integrated internal control framework on a systemwide basis. Each is knowledgeable specifically with respect to the COSO framework. Through these discussions, management will soon be prepared to issue a Request for Proposal to select the firm most qualified to help the University accelerate the adoption of a COSO-based internal control framework. It is expected that this framework will be tailored to the needs of the University of California and will be implemented through broad training programs and facilitated self-assessment of the University's controls on a broad basis.

AUDIT

September 14, 1995

In response to a question from Regent Nakashima regarding the relationship of the core audit program to the COSO framework, Auditor Reed recalled that the original core audit plan which was adopted in 1989 had become extremely cumbersome. In meeting with the Internal Audit Directors, he developed some concerns about the core audit program and consequently asked the Arthur Andersen firm for its recommendations. The old core program no longer exists in its original form. In its place, there is a systemwide planning and risk assessment process. The Internal Auditor allows each campus and laboratory the freedom to determine what to audit, within the framework of the process.

Assessment of the University's Internal Control System

Auditor Reed observed that an effective system of internal controls is the University's primary safeguard against irregularities. In his first presentation to the Committee last March, he stated that the University's internal controls needed to be strengthened. **Since March, the Vice Chancellors for Business and Finance and the Chancellors have endorsed Internal Audit's recommendation that the University adopt the "Internal Control-Integrated Framework" produced by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO.**

The COSO internal control framework is broadly accepted across industry lines as the most comprehensive codification of internal control principles and concepts in existence. It is endorsed by the Association of College and University Auditors and is being adopted and implemented by many leading companies worldwide. Adoption of COSO's principles will provide for the first time a common definition throughout the University of internal controls, their objectives, their component elements, the responsibilities of the Board, management, internal auditors, and other employees, as well as evaluation tools to assess deficiencies and make improvements in the existing systems of control. More importantly, with a COSO implementation initiative, it is hoped that more will be accomplished than to simply tweak this procedure or add that approval. The goal needs to be the achievement of improvement in the overall control environment and improved internal control consciousness and accountability at all levels throughout the University.