



**AUDIT COMMITTEE MEETING
INLAND EMPIRE UTILITIES AGENCY*
AGENCY HEADQUARTERS, CHINO, CA 91708**

**MONDAY, MARCH 6, 2017
9:00 A.M.**

CALL TO ORDER

PUBLIC COMMENT

Members of the public may address the Board on any item that is within the jurisdiction of the Board; however, no action may be taken on any item not appearing on the agenda unless the action is otherwise authorized by Subdivision (b) of Section 54954.2 of the Government Code. Those persons wishing to address the Board on any matter, whether or not it appears on the agenda, are requested to complete and submit to the Board Secretary a "Request to Speak" form, which are available on the table in the Board Room. Comments will be limited to five minutes per speaker. Thank you.

ADDITIONS TO THE AGENDA

In accordance with Section 54954.2 of the Government Code (Brown Act), additions to the agenda require two-thirds vote of the legislative body, or, if less than two-thirds of the members are present, a unanimous vote of those members present, that there is a need to take immediate action and that the need for action came to the attention of the local agency subsequent to the agenda being posted.

1. ACTION ITEMS

A. MINUTES

The Committee will be asked to approve the Audit Committee meeting minutes from December 14, 2016.

B. FISCAL YEAR (FY) 2015/16 SINGLE AUDIT REPORT FOR FEDERAL GRANT PROGRAMS

It is recommended that the Committee/Board

1. Approve the Single Audit Report for FY 2015/16; and
2. Direct staff to distribute the report, as appropriate, to the State Controller's Office, the Federal Audit Clearing House, and other interested parties.

C. THE AUDIT COMMITTEE AND THE INTERNAL AUDIT DEPARTMENT CHARTERS

It is recommended that the Committee/Board

1. Reconfirm the Audit Committee and the Internal Audit Department Charters; and
2. Direct staff to continue to implement the Audit Committee and the Internal Audit Department Charters.

2. INFORMATION ITEMS

A. REPORT ON THE AUDIT FUNCTION (WRITTEN/POWERPOINT)

B. REPORT OF OPEN AUDIT RECOMMENDATIONS (WRITTEN)

C. INTERNAL AUDIT DEPARTMENT STATUS REPORT FOR MARCH 2017 (WRITTEN)

3. GENERAL MANAGER'S COMMENTS

4. COMMITTEE MEMBER COMMENTS

5. COMMITTEE MEMBER REQUESTED FUTURE AGENDA ITEMS

6. ADJOURN

*A Municipal Water District

In compliance with the Americans with Disabilities Act, if you need special assistance to participate in this meeting, please contact the Board Secretary (909-993-1736), 48 hours prior to the scheduled meeting so that the Agency can make reasonable arrangements.

Proofed by: 

DECLARATION OF POSTING

I, Sally Lee, Executive Assistant of the Inland Empire Utilities Agency, A Municipal Water District, hereby certify that a copy of this agenda has been posted by 5:30 p.m. in the foyer at the Agency's main office, 6075 Kimball Avenue, Building A, Chino, CA on Thursday, March 2, 2017.


Sally Lee

**ACTION
ITEM**

1A



**MINUTES
AUDIT COMMITTEE MEETING
INLAND EMPIRE UTILITIES AGENCY*
AGENCY HEADQUARTERS, CHINO, CA
WEDNESDAY, DECEMBER 14, 2016
9:00 A.M.**

COMMITTEE MEMBERS PRESENT

Jasmin A. Hall, Chair
Kati Parker

COMMITTEE MEMBERS ABSENT

None

STAFF PRESENT

Christina Valencia, Chief Financial Officer/AGM
Sally Lee, Acting Executive Assistant
Teresa Velarde, Manager of Internal Audit
Peter Soelter, Senior Internal Auditor
Sapna Nangia, Senior Internal Auditor
Javier Chagoyen-Lazaro, Manager of Accounting & Fiscal Management

OTHERS PRESENT

Travis Hickey, Audit Committee Advisor
Debbie Harper, LSL CPA's
Brandon Young, LSL CPA's

The meeting was called to order at 8:59 a.m. There were no public comments received or additions to the agenda.

ACTION ITEMS

The Committee:

- ◆ Approved the Audit Committee meeting minutes of September 14, 2016.

Recommended that the Board:

- ◆ Approve the Comprehensive Annual Financial Report (CAFR) for the Fiscal Year (FY) ended June 30, 2016; and
- ◆ Direct staff to distribute the report as appropriate, to the various federal, state, and local agencies, financial institutions, bond rating agencies, and other interested parties.

as an Action Item on the December 21, 2016 Board meeting agenda.

INFORMATION ITEMS

The following information items were presented, received, or filed by the Committee:

- ◆ Master Service Contracts Audit
- ◆ Follow-Up Review – Information Technology Equipment Audit – FAD

- ◆ Updates for the Audit Committee and the Internal Audit Department (IAD) Charters
- ◆ Audit Committee Financial Advisor Contract Extension
- ◆ Report of Open Audit Recommendations
- ◆ Internal Audit Department Status Report for December 2016

COMMITTEE MEMBER COMMENTS

There were no Committee Member comments.

COMMITTEE MEMBER REQUESTED FUTURE AGENDA ITEMS

Director Jasmin Hall requested to revisit the Audit Committee and the Internal Audit Department Charters to discuss the responsibilities described within the document at the next Audit Committee meeting. She also requested to bring back the Report of Open Audit recommendations at the next Audit Committee meeting because it was not adequately covered because of time constraints.

With no further business, the meeting adjourned at 10:05 a.m.

Respectfully submitted,

Sally Lee
Acting Executive Assistant

*A Municipal Water District

APPROVED: MARCH 6, 2017

**ACTION
ITEM**

1B

Date: March 15, 2017

To: The Honorable Board of Directors

Through: Audit Committee (3/6/17)
Finance and Administration Committee (3/8/17)

From: P. Joseph Grindstaff
General Manager

Submitted by: Chris Berch
Executive Manager of Engineering/Assistant General Manager

Jason Gu
Grants Officer

Subject: Fiscal Year (FY) 2015/16 Single Audit Report for Federal Grant Programs

RECOMMENDATION

It is recommended that the Board of Directors:

1. Approve the Single Audit Report for FY 2015/16; and
2. Direct staff to distribute the report, as appropriate, to the State Controller's Office, the Federal Audit Clearing House, and other interested parties.

BACKGROUND

The Single Audit Act and Office of Management and Budget (OMB) Circular A-133, *Audits of State, Local Governments, and Non-Profit Organizations*, require each non-Federal entity that expends \$750,000 or more of Federal grants to undergo an annual independent audit.

The objectives of the Single Audit are to determine whether there are issues that could have a direct and material effect over:

1. Compliance for each major federal grant award program.
2. Internal control over compliance requirements of federal grant award programs.
3. Eligibility of federal grant award program expenditures.

In FY 2015/16, IEUA incurred \$6,306,549 in federal costs for the two federal programs listed in the table below. The Agency's independent external audit firm, Lance, Soll & Lunghard, LLP (LSL), performed the annual single audit for fiscal year ended June 30, 2016.

Grantor	Program Title	Federal Expenditures
U.S. Department of the Interior - Bureau of Reclamation (USBR)	Title XVI Desalination Water Reuse Program – Drinking Water	\$6,090,965
United States Environmental Protection Agency (EPA)	Clean Water State Revolving Fund (SRF) Program Recycled Water	\$ 215,584
	TOTAL	\$6,306,549

The Single Audit Report for the FY 2015/16 expressed the following opinion over the Agency's expense of federal funds:

1. IEUA is in compliance with each major federal grant award program.
2. No significant deficiencies in internal control over major federal award programs.
3. No findings or questioned costs to major federal award programs.
4. IEUA qualifies as a "Low-Risk Auditee".

The IEUA FY 2015/16 Single Audit Report is consistent with the Agency's Business Goal of fiscal responsibility in providing transparent communication regarding federal grant award programs.

PRIOR BOARD ACTION

On December 16, 2015, the Board reviewed the FY 2014/15 Single Audit Report presented to the Audit Committee on December 9, 2015.

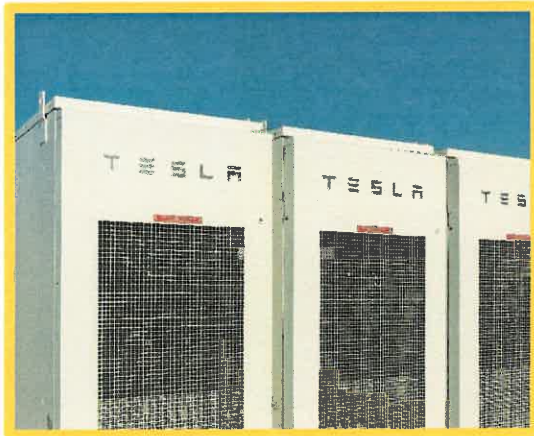
On December 17, 2014, the Board reviewed the FY 2013/14 Single Audit Report presented to the Audit Committee on December 10, 2014.

IMPACT ON BUDGET

The audit fee for the Single Audit Report is within the Agency's FY 2016/17 budget in the Administrative Services (GG) fund (100000/111100/520110) under the professional fees and services category.

Federal Single Audit Report

Board Meeting

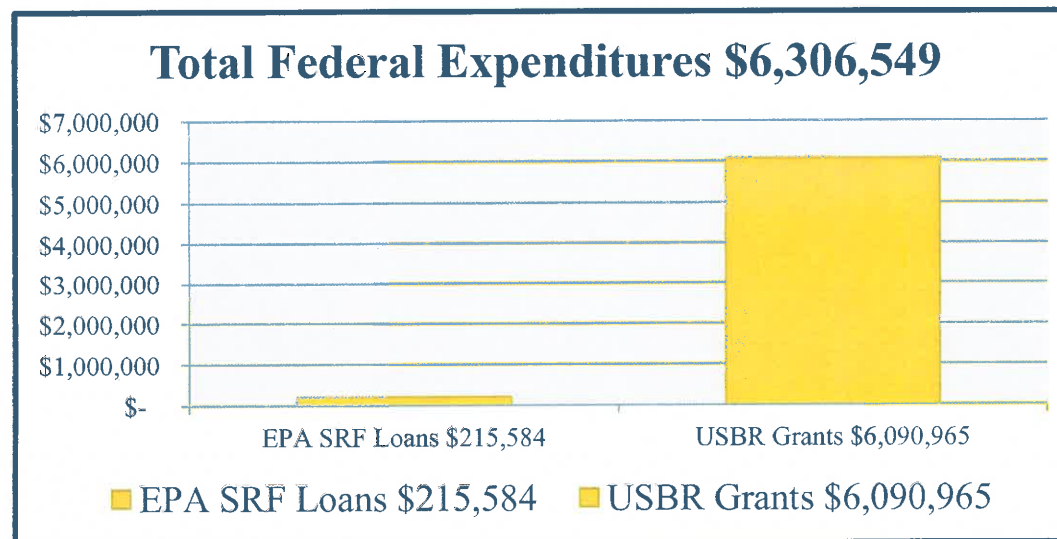


Single Audit Act Requirements

- Each non-federal agency
- Incurred \$750,000 or more in a year
- One audit covers all Federal grant contracts

Federal Cost Incurred FY15/16

- Total Federal Expenditures – \$6,306,549
- USBR Grants – \$6,090,965
- EPA SRF Loans – \$215,584



Single Audit Objectives

- Compliance of federal regulations
- Compliance of grant agreements
- Internal controls
- Grant cost eligibility

IEUA – Single Audit Results

- Unqualified audit opinion (Clean Audit Report)
 - IEUA complied with compliance requirements
 - No deficiencies in internal controls
 - No findings or questioned costs
 - Qualified as low-risk auditee
- Audit result will positively impact future grants

Recommendation

- Approve the FY2015/16 Single Audit Report;
- Direct staff to distribute the report to the State Controller's Office, the Federal Audit Clearing House, and other interested parties.



QUESTIONS?

INLAND EMPIRE UTILITIES AGENCY

SINGLE AUDIT REPORT

JUNE 30, 2016

INLAND EMPIRE UTILITIES AGENCY

SINGLE AUDIT REPORT

JUNE 30, 2016

INLAND EMPIRE UTILITIES AGENCY

SINGLE AUDIT REPORT

JUNE 30, 2016

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE
WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors
Inland Empire Utilities Agency
Chino, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of each major fund, and the aggregate remaining fund information of the Inland Empire Utilities Agency (the Agency), as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the Agency's basic financial statements, and have issued our report thereon dated December 19, 2016.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Agency's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Agency's internal control. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.





CPAs AND ADVISORS

To the Board of Directors
Inland Empire Utilities Agency
Chino, California

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Agency's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Agency's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Lance, Solt & Lingham, LLP

Brea, California
December 19, 2016



CPAs AND ADVISORS

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM AND
ON INTERNAL CONTROL OVER COMPLIANCE; AND REPORT ON SCHEDULE OF EXPENDITURES
OF FEDERAL AWARDS REQUIRED BY UNIFORM GUIDANCE

To the Board of Directors
Inland Empire Utilities Agency
Chino, California

Report on Compliance for Each Major Federal Program

We have audited the Inland Empire Utilities Agency (the Agency)'s compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of the Agency's major federal programs for the year ended June 30, 2016. The Agency's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of the Agency's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Agency's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the Agency's compliance.

Opinion on Each Major Federal Program

In our opinion, the Agency complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2016.





CPAs AND ADVISORS

To the Board of Directors
Inland Empire Utilities Agency
Chino, California

Report on Internal Control over Compliance

Management of the Agency is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Agency's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. *A material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. *A significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Report on the Schedule of Expenditures of Federal Awards Required by Uniform Guidance

We have audited the financial statements of each major fund, and the aggregate remaining fund information of the Inland Empire Utilities Agency, as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the Agency's basic financial statements. We issued our report thereon dated December 19, 2016, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the basic financial statements. The accompanying schedule of expenditures of federal awards is presented for the purposes of additional analysis as required by the Uniform Guidance and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the basic financial statements as a whole.



CPAs AND ADVISORS

To the Board of Directors
Inland Empire Utilities Agency
Chino, California

Purpose of this Report

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

Lance, Soll & Lughard, LLP

Brea, California

February 24, 2017 (except for our report on the Schedule of Expenditures of Federal Awards, for which the date is December 19, 2016)

INLAND EMPIRE UTILITIES AGENCY

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2016

<u>Federal Grantor/Pass-Through Grantor/Program Title</u>	<u>CFDA Number</u>	<u>Grant Identification Number</u>	<u>Federal Expenditures</u>	<u>Amount Provided to Subrecipients</u>
<u>U.S. Department of the Interior - Bureau of Reclamation</u>				
Direct Programs:				
Title XVI Water Reclamation and Reuse*	15.504	R11AC35306	\$ 171,195	\$ 171,195
Title XVI Water Reclamation and Reuse*	15.504	R12AC35339	31,368	31,368
Title XVI Water Reclamation and Reuse*	15.504	R14AC00049	964,475	964,475
Title XVI Water Reclamation and Reuse*	15.504	R15AC00059	4,923,927	4,923,927
Total U.S. Department of the Interior - Bureau of Reclamation			6,090,965	6,090,965
<u>U.S. Environmental Protection Agency</u>				
Passed through the State of California, State Water Resources Control Board:				
Capitalization Grants for Clean Water State Revolving Funds	66.458	C-06-7885-110	215,584	-
Total U.S. Environmental Protection Agency			215,584	-
Total Federal Expenditures			\$ 6,306,549	\$ 6,090,965

* Major Program

Note a: Refer to Note 1 to the schedule of expenditures of federal awards for a description of significant accounting policies used in preparing this schedule.

Note b: There were no federal awards expended in the form of noncash assistance and insurance in effect during the year.

INLAND EMPIRE UTILITIES AGENCY

**NOTE TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2016**

Note 1: Summary of Significant Accounting Policies Applicable to the Schedule of Expenditures of Federal Awards

a. Scope of Presentation

The accompanying schedule presents only the expenditures incurred by the Inland Empire Utilities Agency (the Agency), that are reimbursable under federal programs of federal financial assistance. For the purposes of this schedule, federal awards include both federal financial assistance received directly from a federal agency, as well as federal funds received indirectly by the Agency from a non-federal agency or other organization. Only the portion of program expenditures reimbursable with such federal funds is reported in the accompanying schedule. Program expenditures in excess of the maximum federal reimbursement authorized or the portion of the program expenditures that were funded with state, local or other non-federal funds are excluded from the accompanying schedule.

b. Basis of Accounting

The expenditures included in the accompanying schedule were reported on the modified accrual basis of accounting. Under the modified accrual basis of accounting, expenditures are incurred when the Agency becomes obligated for payment as a result of the receipt of the related goods and services. Expenditures reported included any property or equipment acquisitions incurred under the federal program. The Agency has elected not to use the 10-percent de minimis indirect cost rate allowed under the Uniform Guidance.

Note 2: Reconciliation of State Water Resource Control Board and GAAP Expenditure Reporting

For the year ended June 30, 2016, the following adjustments were necessary to reconcile the federal awards provided to the Agency for the Capitalization Grants for Clean Water State Revolving Funds federal awards program per the State Water Resource Control Board's records to the federal expenditures reported by the Agency under accounting principles generally accepted in the United States of America (GAAP).

Federal awards per the State Water Resource Control Board:	
C-06-5318-110	\$ 5,002,216
C-06-7885-110	236,824
	<hr/>
Subtotal	5,239,040
	<hr/>
Adjustment for expenditures reported in the prior fiscal period:	
C-06-5318-110	(5,002,216)
C-06-7885-110	(21,240)
	<hr/>
Subtotal	(5,023,456)
	<hr/>
Total Federal Expenditures of the Capitalization Grants for Clean Water State Revolving Funds Program (GAAP)	\$ 215,584
	<hr/> <hr/>

INLAND EMPIRE UTILITIES AGENCY

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 2016**

SECTION I - SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued: Unmodified Opinion

Internal control over financial reporting:

- Significant deficiencies identified? ___yes X no
- Material weaknesses identified? ___yes X none reported

Noncompliance material to financial statements noted? ___yes X no

Federal Awards

Internal control over major programs:

- Significant deficiencies identified? ___yes X no
- Material weaknesses identified? ___yes X none reported

Type of auditors' report issued on compliance for major programs: Unmodified Opinion

Any audit findings disclosed that are required to be reported in accordance with Uniform Guidance? ___Yes X no

Identification of major programs:

<u>CFDA Number(s)</u>	<u>Name of Federal Program or Cluster</u>
15.504	Title XVI Water Reclamation and Reuse

Dollar threshold used to distinguish between type A and type B program \$750,000

Auditee qualified as low-risk auditee? X yes ___no

INLAND EMPIRE UTILITIES AGENCY

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE YEAR ENDED JUNE 30, 2016**

SECTION II - FINANCIAL STATEMENT FINDINGS

No matters were reported.

SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

No matters were reported.

INLAND EMPIRE UTILITIES AGENCY

**SCHEDULE OF PRIOR YEAR FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 2015**

SECTION IV - FINANCIAL STATEMENT FINDINGS

No matters were reported.

SECTION V - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

No matters were reported.

**ACTION
ITEM**


1C



Date: March 15, 2017

To: The Honorable Board of Directors

Through: Audit Committee (3/6/2017)

From: 
Teresa V. Velarde
Manager of Internal Audit

Subject: The Audit Committee and the Internal Audit Department Charters

RECOMMENDATION

It is recommended that the Board of Directors:

1. Reconfirm the Audit Committee and the Internal Audit Department Charters; and
2. Direct staff to continue to implement the Audit Committee and the Internal Audit Department Charters.

BACKGROUND

The Internal Audit Department Charter states that the Internal Audit Department is responsible for performing periodic reviews of both the Audit Committee Charter and the Internal Audit Department Charter and making recommendations for any necessary updates and revisions. Attached are the charters presented in their current form. There are no proposed changes, but the Charters are available for your review, discussion and further direction.

The Audit Committee Charter defines and documents the Audit Committee's purpose, composition, authority, and responsibilities. The purpose of the Audit Committee is to assist the Board of Directors in fulfilling their oversight responsibilities over financial reporting, internal controls, and compliance with legal and regulatory requirements related to the operations of the Agency. The responsibilities of the Audit Committee include inquiring of Agency management, the Manager of Internal Audit, the external auditors, and legal counsel about the Agency's internal controls, financial reporting, organizational risks, legal compliance matters, results of internal audits, organizational goals, and other matters as they relate to the Agency. The Charter is reviewed annually but was last amended in December 2015.

The Internal Audit Department Charter defines and documents the Internal Audit Department's (IA) purpose, mission, authority, and responsibilities. The purpose of IA is to assist the Board and the Audit Committee in fulfilling their oversight responsibilities for financial reporting, internal controls, and compliance with legal and regulatory requirements applicable to Agency operations.

The Audit Committee and the Internal Audit Department Charters

March 15, 2017

Page 2 of 2

The purpose of IA is also to provide objective, independent assurance evaluations about the operations of the Agency as well as recommendations to improve efficiencies, establish compliance with policies and procedures, protect Agency assets, and mitigate risks. The responsibilities of IA include performing reviews to evaluate internal controls, report findings and recommendations to management, the Audit Committee and the Board. The IA Charter is reviewed annually but was last amended in December 2015.

IA staff evaluated updates proposed by the Institute of Internal Auditors and worked with the Audit Committee's Financial Expert Advisor to ensure both charters incorporate leading practices.

The Charters were submitted as an information item during the December meeting Audit Committee Meeting to take comments, changes, or proposed edits and updates from senior management, the Audit Committee Advisor, the Audit Committee and the Board of Directors, as well as direction to finalize. The Charters are being submitted through the Audit Committee for Board of Directors approval.

The attachments include the Audit Committee Charter and the IA Department Charter.

The updates for the Audit Committee and the Internal Audit Department Charters is consistent with the Agency's Business Goals of *Fiscal Responsibility, Workplace Environment and Business Practices* by providing direction and guidance for the Audit Committee and the Internal Audit Department.

PRIOR BOARD ACTION

On December 21, 2016, the Board of Directors received the Audit Committee and Internal Audit Charters.

On December 16, 2015, the Board of Directors reconfirmed the amended Audit Committee and Internal Audit Charters.

On December 18, 2013, the Board of Directors approved the revised Audit Committee and Internal Audit Charters.

On December 15, 2010, the Board of Directors approved the revised Audit Committee Charter.

On December 9, 2009, the Board of Directors approved the revised Internal Department Charter.

On April 21, 2004, the Board of Directors approved the establishment of an Audit Committee of the Board of Directors, the new position of Internal Auditor, and the new position of Assistant Auditor.

IMPACT ON BUDGET

None.



INLAND EMPIRE UTILITIES AGENCY
Audit Committee Charter
Reconfirmed on March 15, 2017

PURPOSE

The Audit Committee (Committee) is established under the authority of the Inland Empire Utilities Agency (IEUA or Agency) Board of Directors (Board) and reports directly to the Board. The primary purpose of the Committee is to assist the Board in fulfilling their oversight responsibilities for financial reporting, internal controls, and compliance with legal and regulatory requirements applicable to Agency operations.

While assisting the Board with these fiduciary duties, the Committee also provides an open avenue of communication between the Board, IEUA Management, the Internal Audit Department, and the external auditors. This advisory and oversight link provides the following benefits to the organization and stakeholders:

- Increased objectivity and credibility of financial reports.
- Increased management accountability.
- Support for measures to improve management performance and internal controls.
- Increased employee awareness of unethical, questionable, or illegal activities.
- Enhanced independence and effectiveness of the Internal Audit Department.
- Assurance that appropriate management action plans are implemented for audit findings and recommendations.

COMPOSITION, COMPENSATION & TERM OF SERVICE

The Committee shall consist of two members from the Board of Directors, each with equal voting rights, with one selected as the Committee Chairperson. The members will be appointed by the Board President.

The Audit Committee shall have access to at least one financial expert, an outside party with no voting rights, who will provide advisory and consulting duties and shall be compensated as agreed upon, in writing with the Audit Committee, the Board, Agency management and its designees.

All members of the Audit Committee shall possess or obtain a basic understanding of governmental financial reporting, accounting and auditing and shall have a requisite interest in financial reporting issues of the Agency. The financial expert shall be an individual with sufficient financial experience and interest to provide guidance and assistance to the Audit Committee. The financial expert should through both education and experience, and in a manner specifically relevant to the government sector, possess: 1) an understanding of generally accepted accounting principles and financial statements; 2) experience in preparing or auditing financial statements of comparable entities; 3) experience in applying such principles in connection with the accounting for estimates, accruals, and reserves; 4) experience with internal accounting controls; and 5) an understanding of Audit Committee functions.

INLAND EMPIRE UTILITIES AGENCY
Audit Committee Charter
Reconfirmed on March 15, 2017

The members of the Board serving on the Audit Committee shall be compensated in accordance with the guidelines established for the IEUA Board of Directors in Ordinance No. 98 adopted May 21, 2014, and as amended from time to time, entitled:

"Ordinance of the Inland Empire Utilities Agency, a Municipal Water District, San Bernardino County, California, establishing compensation/benefits and authorizing reimbursement of expenses for the Board of Directors and their appointed representatives to the Metropolitan Water District of Southern California Board of Directors and outside Committee Members."

The service term for each Committee member will be two years. Prior to term expiration, the Board President or their designee will conduct a review of Board Committee members' eligibility and the Board of Directors will conduct a review of the external/outside Committee member's eligibility. The Board President will then reconfirm the Committee members or select and confirm new members as needed. All activities and actions pertaining to selection or reconfirmation of Committee members will be documented by the Board, or their designee, and recorded in the next regularly scheduled IEUA Board of Directors' meeting minutes.

AUTHORITY

The Audit Committee has unrestricted access to all information and records, including IEUA personnel and documents. The Committee will have adequate resources to fulfill its oversight responsibilities, including the right to seek independent professional advice and counsel. The Committee is empowered to:

- Meet, as deemed appropriate and necessary, with IEUA Management and employees, the Manager of Internal Audit and audit staff, external auditors and legal counsel.
- Recommend to the Board the approval of the Internal Audit Department's Annual Audit Plan and any changes to the Plan or the Manager of Internal Audit duties.
- Authorize special audits and investigations into any matters within its scope of responsibility.
- Authorize an internal audit or review of any department or function under the control of the Board of Directors, or within the scope of influence of the IEUA.
- Recommend to the Board the appointment, compensation and scope of work of any public accounting firm employed by the IEUA.
- Recommend to the Board the approval of any auditing and consulting services.

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- Review and recommend to the Board the external auditor's audit scope and approach, ensuring that the scope:
 1. Is in compliance with Generally Accepted Auditing Standards (issued by the American Institute of Certified Public Accountants).
 2. Is in compliance with Government Auditing Standards (issued by the Government Accountability Office).
 3. Will include a Single Audit that will be performed, if required, subject to the Office of Management and Budget (OMB) Circular A-133.
 4. Will include an opinion on each major fund presented in the Agency's financial statements.
- Review and recommend to the Board the approval of external auditors' reports, along with management's written responses, when appropriate.
- Resolve any disagreements between management, the Internal Audit Department, and the external auditors regarding financial or operational controls and reporting.
- Ensure corrective action is taken on internal accounting control weaknesses identified by the internal and external auditors.

RESPONSIBILITIES

The Audit Committee is chartered with performing oversight for the Board of Directors. In addition to reviewing this Charter annually and updating it as needed, the Committee has responsibilities in the areas of Financial Reporting, Internal Controls, the Internal Audit Department, the External Audit and external auditors, compliance requirements, and other matters as provided in the following sections. The Committee has the overall responsibility to ensure the general requirements underlying these items are carried out. However, the Audit Committee has the flexibility and authority to determine and choose the best course of action and the best method for carrying out its responsibilities. The following items are best practice guidelines that may be employed:

Financial Reporting:

- Review annual financial statements and consider whether they are complete, consistent with information known to Committee members, and reflect appropriate accounting principles.
- Advise the Board and management of any situations that would cause the Committee to believe the audited financial statements may contain material misstatements or omissions.
- Inquire of the General Manager and Chief Financial Officer (CFO) regarding the fiscal health of the Agency as well as the financial status of the Agency in relation to its adopted budget.
- Inquire of management, the Manager of Internal Audit, and the external auditors about whether significant financial, managerial, and operational information is accurate, reliable, complete, and timely.
- Inquire of Agency management, the Manager of Internal Audit, and the external auditors about significant risks or exposures facing the Agency; assess the steps management has

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taken or proposes to take to minimize such risks to the Agency; and periodically review compliance with such steps.

Internal Controls:

- Discuss with Agency management, the Manager of Internal Audit, and the external auditors the reliability and effectiveness of the Agency's internal control environment to mitigate risk, including information technology security and control.
- Discuss with Agency management, the effectiveness of the Agency's process for identifying and assessing significant risks and exposures, and the steps Agency management has taken to communicate, monitor and mitigate these risks.
- Understand the scope of the internal and external auditors' reviews of internal controls, and obtain and review reports of significant findings, recommendations, and Agency management's action plans to mitigate risks.
- Review all significant accounting policy changes submitted by Agency management with the Internal Audit Department, and/or the external auditors, and provide recommendations to the Board and Agency management.
- Periodically review Agency policies and procedures governing Board of Director and employee conduct, including conflict of interest, misconduct, fraud and other sensitive issues or non-compliance and recommend changes to the Board and Agency management as appropriate.
- Discuss with Agency management, the Manager of Internal Audit, and the external auditors whether adequate policies have been established and the Agency complies with policies, standards and applicable laws and regulations.
- Discuss with Agency management, the Manager of Internal Audit, and the external auditors whether significant legislative or regulatory issues impacting Agency operations are identified, recognized, communicated and appropriately addressed.
- Review with Agency management, the Manager of Internal Audit, and the external auditors the audit scope and plan of the Internal Audit Department and the external auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.
- Review with Agency management and the Manager of Internal Audit:
 - Significant findings, recommendations, and management's responses thereto.
 - Any difficulties the Internal Audit Department encountered in the course of their audits, including any restrictions on the scope of their work or access to required information.
 - Any changes required in the scope of their internal audits.
 - The Internal Audit Department budget and staffing.
 - The Internal Audit Department Charter.
 - The Internal Audit Department's compliance with applicable standards (for example, Governmental Auditing Standards, or the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing).

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- Periodically review the Agency's Code of Conduct/Ethics Policy to ensure that it is adequate and up to date.
- Review with the Manager of Internal Audit and the Agency's general counsel the results of their reviews of compliance monitoring with the Code of Conduct/Ethics Policy.
- Review the procedures for the receipt, retention, and treatment of complaints received by the Agency regarding accounting, internal accounting controls, auditing matters, or suspected fraud that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, the current status, and resolution if one has been reached.
- Review procedures for the confidential, anonymous submission by Agency employees of concerns regarding questionable accounting or auditing matters, or suspected fraud. Review any submissions that have been received, the current status, and the resolution if one has been reached.
- Inquire of Agency management, the Manager of Internal Audit, and the external auditors about significant risks or exposures facing the Agency. Assess the steps management has taken or proposes to take to communicate, manage, and minimize such risks to the Agency; and periodically review compliance with such steps.
- Review with the Manager of Internal Audit, and the external auditors:
 - The adequacy of the Agency's internal controls including computerized information system controls and security.
 - Any significant findings and recommendations of the Manager of Internal Audit, and the external auditors together with management's responses thereto.

Internal Audit Department:

- Request that the Agency's Manager of Internal Audit prepare the Audit Committee's meeting agendas designed to ensure that all of the responsibilities of the Audit Committee as described herein are addressed at least once a year.
- Ensure there are no unjustified restrictions or limitations placed on the Internal Audit Department.
- Review with the Board, General Manager, and the Manager of Internal Audit the Internal Audit Department Charter, Annual Audit Plan, staffing, budget, and organizational reporting structure to ensure they meet the Committee's goals, objectives, and responsibilities to the Board and Agency management.
- Review and recommend to the Board the approval of the Internal Audit Department's Annual Audit Plan and any significant changes that may occur during the year.
- Review, as needed, all internal audit reports, findings, and recommendations.
- Review and recommend to the Board the appointment, replacement, dismissal, or change in duties of the Manager of Internal Audit.
- Review the effectiveness of the Internal Audit Department's function, including compliance with The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (Standards)*.

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- Conduct the Manager of Internal Audit performance appraisals and recommend Manager of Internal Audit merit increases and incentive compensation to the Board.
- Hold management accountable for the appropriate resolution of Internal Audit Department's recommendations and ensure that disposition has been determined for Audit Department recommendations from the prior year. If management has determined that Internal Audit Department recommendations need not be implemented because of adequate compensating controls, based upon a cost/benefit analysis or because the risks are at an acceptable level in accordance with the Agency's goals and objectives, evaluate the reasonableness of such determinations and advise the Board of Directors accordingly.

External Audit:

- Review the external accounting firm's proposals and fee structure, and provide recommendations and external audit plan approval to the Board.
- Review the external auditors' proposed audit scope and approach to ensure emphasis is placed on areas the Committee, Board, Management and external auditors believe special attention is warranted and that efforts are coordinated with the Internal Audit Department.
- Evaluate the external auditor's independence, and if needed, recommend the Board take the appropriate action to satisfy the Agency with the external auditor's independence.
- Review the effectiveness of the external auditor's work and provide the Board with the final approval to continue or discharge the current firm.
- Communicate to the external auditors areas of internal control with a heightened risk of fraud or error, any known or suspected employee fraud, management fraud, pressures or incentives for management to distort reported financial results, or any known or suspected accounting errors or misstatements.
- Communicate to the external auditors any areas of concern applicable to the external auditors' scope of responsibility (fraud, errors, or misstatements involving amounts significant to the financial statements taken as a whole).
- Review all significant written communications between the external auditors and management, such as any management letter comments or schedule of unadjusted differences (i.e. management letter, schedule of audit, or significant unusual or non-routine items, etc.)
- Hold management accountable for the appropriate resolution of external auditor recommendations, ensure that disposition has been determined for auditor recommendations from the prior year, and where management has determined that auditor recommendations need not be implemented because of adequate compensating controls or based upon a cost/benefit analysis, evaluate the reasonableness of such determinations and advise the Board of Directors accordingly.
- Review with the external auditor that performs the financial statement audit:
 - All critical accounting policies and practices used by the Agency.
 - All alternative treatments of financial information within generally accepted accounting principles that have been discussed with the Agency's management, the ramifications of each alternative, and the treatment preferred by the Agency.

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- Review with management and the external auditors:
 - The Agency's annual financial statements, related notes, and management's discussion and analysis.
 - The external auditors' audit of the financial statements and their report thereon.
 - The external auditors' judgments about the quality, not just the acceptability, of the Agency's accounting principles as applied in its financial reporting.
 - The external auditors' single audit of the federal awards administered by the Agency and their reports thereon.
 - Any significant changes required in the external auditors' audit plan.
 - Any serious difficulties or disputes with management encountered during the audit.
 - Matters required by Statement on Auditing Standards (SAS) No. 114, The Auditor's Communication With Those Charged With Governance; U.S. Government Accountability Office's (GAO) Government Auditing Standards; and the U.S. Office of Management and Budget's Circular A-133 related to the conduct of the audits.

- Evaluate whether or not the performance of any extra work or special projects requested of the Agency's external audit firm violates the independence standards of the GAO.

- Recommend that the Board of Directors approve the Agency's annual financial report, if the Committee believes that they are fairly presented, to the extent such a determination can be made on the basis of reading the financial statements and discussions with Agency management and the external auditors.

Compliance:

- Review with management and the external auditors the Agency's internal controls for identifying laws and regulations affecting operations, risks for non-compliance including litigation and fines, and implementing controls to prevent recurrence.
- Review the reports, findings and recommendations of any audits or examinations performed by external agencies.
- Review with Agency counsel any legal, tax, or regulatory matters that may have a material impact on the Agency's operations and its financial statements.

Other Matters:

- The Audit Committee shall engage consultants, specialists, or other audit firms as necessary to assist the committee in the discharging of its responsibilities.
- The Audit Committee shall direct the Manager of Internal Audit to review the Agency's Audit Committee Charter annually in order to advise the Audit Committee as to needed or recommended changes.

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- The Audit Committee shall report to the Board of Directors issues discussed in the Audit Committee meeting that, in the judgment of the committee, warrant communication to the Board to help the Board fulfill its oversight responsibility.

ETHICAL CONDUCT

Audit Committee members are prohibited from participating in any event or matter that would create, or appear to create, a conflict of interest. These activities may include having a significant financial interest or operational influence in vendors, contractors, customers or competitors of IEUA. Any activity creating an actual or apparent conflict should be immediately reported to the Audit Committee Chair and the Board of Directors for resolution.

MEETINGS

The Audit Committee shall meet no less than quarterly.

The Manager of Internal Audit will schedule and coordinate all quarterly Committee meetings, and will call additional meetings if requested to do so by any Committee member, the Board, the General Manager or the external auditors. The Manager of Internal Audit will provide all Committee members with written notification and an agenda at least 72 hours before the scheduled quarterly meetings or as soon as reasonably possible for any special meetings, all in accordance with the requirements of the Brown Act.

The General Manager and Manager of Internal Audit will be provided written notification and an agenda at least 72 hours before quarterly and special Committee meetings. These parties will be provided an opportunity to attend and speak at all Committee meetings but are not considered members of the Committee and have no voting rights.

The Board or the General Manager will provide administrative support to the Audit Committee and its meetings, including agenda preparation, participant notification, and documentation of meeting minutes.



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Internal Audit Department Charter

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PURPOSE

This Charter establishes the authority and responsibilities of the Inland Empire Utilities Agency (IEUA or Agency) Internal Audit Department.

The purpose of the Internal Audit Department (Internal Audit or IA) is to assist the Board of Directors (Board) and the Audit Committee (Committee) in fulfilling their oversight responsibilities for financial reporting, internal controls, and compliance with legal and regulatory requirements applicable to Agency operations and to provide objective assurance about the Agency's operations. The purpose of the Internal Audit Department is also to provide as a service to management and as a way of adding value to improve the operations of the Agency, consulting services, analyses, recommendations, and information concerning operations.

The Internal Audit Department reports to the Board through the Committee and is an independent function from management. The responsibilities of the Internal Audit Department are defined in this Charter.

MISSION

The Internal Audit Department seeks to improve the operations of the Agency by providing unbiased and objective assessments and recommendations to ensure Agency resources are efficiently and effectively managed in order to achieve Agency goals and objectives. The Internal Audit Department will help the Agency achieve its goals and objectives, improve operations, and instill confidence among its employees and the citizens it serves by providing independent, objective assurance and consulting services and provide management and the Board of Directors with recommendations to:

- Promote and strengthen a sound control environment.
- Improve Agency risk management, control and governance.
- Promote the Agency's vision and mission through a high degree of professionalism.
- Establish adequate policies and procedures and to comply with them.
- Encourage efficient use of Agency resources.
- Protect and safeguard Agency assets.
- Mitigate risks related to fraud, waste and abuse.
- Hold staff accountable for the resolution of audit recommendations.

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VALUES

The Internal Audit Department has adopted the following value statements that form the foundation for the Internal Audit Department.

Independence

As documented in this Charter, the Internal Audit Department is an independent function of the Agency for the purpose of providing independent, objective, unbiased opinions.

Integrity

The Internal Audit Department staff is required to maintain the highest degree of integrity in conducting its audit work.

Professionalism

The Internal Audit Department will perform its work with due professional care at all times.

Collaboration

The Internal Audit Department will foster collaboration with all Agency personnel to promote teamwork within the various business units.

ACCOUNTABILITY

The Internal Auditor is the Manager of the Internal Audit Department. The Internal Auditor is accountable and reports to the Board of Directors, through the Audit Committee appointed by the Board. The intent of this reporting relationship is to establish the Internal Audit Department's independence to function effectively and in accordance with best practices.

Annually, the Internal Auditor will submit an Audit Plan for the following fiscal year to the Committee for review and approval by the Board. Quarterly status reports of significant Internal Audit activities shall be presented at Committee meetings and shall include a status of major activities and any changes or deviations from the approved audit plan. The Internal Auditor has the authority to deviate from the approved annual Audit Plan, when necessary and if warranted by unforeseen issues that require immediate attention. Significant changes to the annual Audit Plan shall be reported to the Committee and to the Board.

Annually, a listing of audit recommendations provided by the Internal Audit Department and the corresponding corrective actions taken by Agency management will be presented to the Committee.

The Internal Auditor shall inform the Committee on the sufficiency of department staffing and resources.

Annually, the Internal Audit Department must also ensure the Committee fulfills their responsibilities as required under the Audit Committee Charter. Additionally, IA must ensure the

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Internal Audit Department Charter and the Audit Committee Charter are reviewed annually and updated as necessary.

INDEPENDENCE

Independence is essential to the effectiveness of internal auditing and is strongly emphasized by the Institute of Internal Auditors (IIA), the American Institute of Certified Public Accountants (AICPA), and the U. S. General Accountability Office (GAO). The Internal Audit Department should be free, both in fact and appearance, from impairments to independence.

The Internal Auditor and the Internal Audit Department shall have no direct responsibility or authority over the day-to-day operations of the Agency or any activities they would audit. The Internal Audit Department shall not engage in any activities that would compromise their independence or would appear to be a conflict of interest.

To ensure independence is maintained, the Internal Audit Department shall report administratively to the Agency's General Manager or his designee and functionally to the Board through the Audit Committee, as stated under "Accountability".

AUTHORITY

The Internal Audit Department's authority is derived from the direction of management and the Agency's Board through the Committee as set forth in this Charter. Specifically, the Internal Audit Department is authorized to:

- Audit all areas of the Agency's operations. Perform audits of the Regional Sewage Service Contract agreement between the Agency and the Regional Contracting Agencies (RCA), including performing necessary audit field work and review of required supporting information and documents of the RCA's.
- Have unrestricted access to all Agency functions, records, information, property, and personnel.
- Have full and free access to Agency management, the Board of Directors and the Audit Committee.
- Allocate resources, set frequencies, select subjects and set objectives, determine the scope of work, and apply the techniques required to accomplish audit objectives, without interference from management.
- Obtain the necessary assistance of Agency staff where Internal Audit performs audits, as well as other specialized services from within or outside the organization.
- Obtain regular updates from management and Agency legal counsel regarding compliance matters affecting operations.

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- Establish procedures for the receipt, retention, and treatment of comments or complaints received regarding Agency accounting, operations, or internal controls, including those matters received through Ethics Point or other channels.
- Investigate and make recommendations to the Board, Audit Committee, Executive Management and/or Human Resources, as appropriate about reported instances of inappropriate activities, misappropriation of funds or fraud, including those matters received through Ethics Point or other channels.
- Obtain additional internal or external resources when the Internal Audit Department does not possess all the necessary skills or experience to complete an audit or review, subject to the approval of the Audit Committee and when necessary from the Board.

The Internal Auditor and the Internal Audit Department staff are **not** authorized to:

- Have any responsibilities or authority for any of the activities they audit or perform any operational duties for the Agency or its affiliates.
- Initiate or approve accounting transactions external to the Internal Audit Department.
- Direct the activities of any organization employee not employed by the Internal Audit Department, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the Internal Auditor in audit activities.
- Participate in any activities that would compromise their objectivity and independence or any activities that would appear to be a conflict of interest.
- Draft or write any Agency Policies and Procedures, or Standard Operating Procedures outside the Internal Audit Department.

RESPONSIBILITIES

The responsibilities of the Internal Audit Department consist of the examination, review and evaluation of the reliability and effectiveness of the Agency's governance, risk management, internal controls, and the quality of operations and systems utilized in carrying out the Agency's goals and objectives. The Internal Audit Department has the responsibility to perform its work with due professional care.

The Internal Auditor and audit staff shall be responsible for, but not limited to, incorporating periodically, as deemed necessary and/or in agreement with the annual audit plan, activities in the following key areas:

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Internal Controls

- Assess the adequacy of internal controls in place and determine if they are operating effectively.
- Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
- Review compliance with Agency policies and procedures, and with applicable laws and regulations which could have a significant impact on the operations of the Agency.
- Evaluate the means implemented and the extent Agency assets are identified, tracked, and safeguarded against misuse, unauthorized use, theft and loss.
- Review operations, programs or projects to determine if results are consistent with established objectives and goals.
- Assess the efficient and effective use of Agency resources and the controls over those resources.
- Provide consulting services on current and proposed policies, procedures, and systems to ensure adequate internal controls are considered and maintained.
- Provide consulting services to evaluate contractual agreements and determine if compliance exists.
- Use documents and information obtained from Departments in the same prudent manner as by those employees who are normally accountable for them.
- Perform “Follow-up Procedures” on all management responses to audit findings and recommendations to determine if internal control improvements and/or corrective actions have been implemented.
- Perform “Follow-up Procedures” on known external auditor’s or regulatory agency’s reported findings and recommendations to determine if internal control improvements and/or corrective actions have been implemented.
- Conduct special projects, studies, or audits as requested by management, the Audit Committee and the Board of Directors.
- Ensure known or suspected acts of fraud or improprieties involving Agency funds, property and employees are investigated in coordination with the Agency’s legal counsel, Human Resources and senior management.

Audit

- Conduct work in accordance with the *International Standards for the Professional Practice of Internal Auditing (Standards)* and Code of Ethics as required by the Institute of Internal Auditors (IIA).
- Develop a comprehensive and flexible annual audit plan using an appropriate risk-based methodology, including consideration of any risks or control concerns identified by management, the Audit Committee, the Board or the external auditor and submit that plan, as well as any periodic updates, to the Audit Committee and the Board for review and approval.
- Implement the annual audit plan, as approved, including as appropriate, any special tasks or projects requested by management, the Audit Committee, or the Board.

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- Provide Agency management with reasonable notice of intent to audit and with information about the audit process, except in those situations that warrant an unannounced audit.
- Consider the scope of work of the external auditors for the purpose of providing optimal audit coverage, at a reasonable cost, without redundancy or omission.
- Perform advisory services to assist the Agency in achieving its objectives; for example, reviewing controls, systems or process designs prior to implementation and providing recommendations to improve and enhance the effectiveness of controls and operations.
- Maintain a professional audit staff with sufficient knowledge, skills, experience, and professional certifications to meet the requirements of this Charter.
- Maintain technical competence through continuing education supported by Department goals and budgets.
- Maintain a quality assurance program whereby the Internal Auditor assures the operations of the Internal Audit Department.
- Perform a periodic review of the Internal Audit Department Charter and the Audit Committee Charter. Additions, deletions, or other changes to the Charters are subject to the approval of the Board of Directors.

Reporting

- Issue quarterly reports to and meet with the Audit Committee and management to summarize results of audit activities and status of findings and recommendations.
- Provide written status reports of Audit Department activity to the Audit Committee quarterly. The Quarterly Audit Committee Status Report will include a summary of significant internal and external audit activities for the reporting period. The Status Report will be submitted for approval by the Committee and the approved Status Report will be presented at the next regularly scheduled IEUA Board of Directors meeting.
- Provide a written report listing all outstanding recommendations with expected resolution dates annually. The report of all outstanding recommendations will be submitted for approval by the Audit Committee and provided at the next regularly scheduled IEUA Board of Directors meeting.
- Keep the Audit Committee informed of emerging trends and successful practices in internal auditing, as well as new audit requirements, when applicable.
- Immediately report any reservations concerning control risks, accounting or disclosure practices to the Audit Committee.
- If during the scope and progress of its reviews and audits, the Internal Audit Department identifies opportunities for improving the Agency's control environment, processes and procedures to ensure an environment where assets are safeguarded, internal controls are in place and risk is mitigated, these recommendations will be communicated to the appropriate level of management and the Audit Committee as timely as necessary and in the written report.
- When deemed appropriate and necessary, provide responsible unit management with a preliminary written report of the results and recommendations of each audit, analysis, review, or investigation performed and sufficient time to respond in writing with a plan of

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corrective actions. Sufficient time to reply would be 30 to 60 days from the date of the final report.

- Provide final reports of results and recommendations for each review and audit performed, including the responsible management's responses to the Audit Committee, Executive management and responsible management. All final reports with any responses will be submitted to the Committee for discussion and to the Board for approval. However, in cases where the auditee does not provide a response that is timely or deemed responsive, the final report will not be held up pending a response and will be submitted for discussion during the next scheduled Audit Committee meeting.

STANDARDS OF ETHICAL CONDUCT

The Internal Audit Department staff have a responsibility to govern themselves so that their independence is not open to question. To this end, adherence to the Institute of Internal Auditor's "Code of Ethics" will ensure integrity, objectivity, confidentiality and competency in Internal Audit work performed on behalf of the Agency's Board and Audit Committee. These principles include:

- Performing internal auditing services in accordance with the *International Standards for the Professional Practice of Internal Auditing (Standards)*.
- Exercising honesty, diligence, and responsibility in performing duties.
- Observing the law and making disclosures expected by the law and the profession.
- Not knowingly being a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the Agency.
- Respect and contribute to the legitimate and ethical objectives of the Agency.
- Not participating in any activity or relationship that may impair, or be presumed to impair, unbiased assessments, including activities or relationships that may be in conflict with the interests of the Agency.
- Not accepting anything that may impair or be presumed to impair professional judgment.
- Disclosing all material facts known that, if not disclosed, may distort the reporting of activities under review.
- Being prudent in the use and protection of information acquired in the course of duties.
- Not using information for personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the Agency.
- Engaging in only those services or audit activities for which Internal Audit staff have the necessary knowledge, skills, and experience.
- Continually improving staff proficiency, and the effectiveness and quality of services.

MANAGEMENT RESPONSIBILITIES

It is the responsibility of the Board of Directors and senior management to foster a control environment that supports the Internal Audit Department's objectives and independence within the

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Inland Empire Utilities Agency. The existence of the Internal Audit Department does not diminish Agency management's financial and operational responsibilities for prudent execution and control of activities, including their responsibilities for the periodic evaluation of risk, control, and governance systems.

Management's responsibilities include:


- Providing Internal Audit with its full support and cooperation at all operating levels, including full and complete access to all records, property, and staff relative to their assigned areas of responsibility, and active participation in the audit process.
- Immediately notifying the Manager of Internal Audit and the Audit Committee of any known or suspected cases of illegal, criminal or unethical activity involving Agency funds, property, employees, or any activity which appears to present a conflict of interest.
- Timely notification to Internal Audit of any new or proposed modifications to Agency systems, procedures, operations or services, ensuring controls are built into the new or modified processes.
- Providing the Internal Audit Department with written responses to all audit findings and recommendations, including action plans, responsible employees, and targeted resolution dates or the acceptance of the risks identified.
- Providing the Internal Audit Department with adequate budget, staffing, assistance from staff of audited Departments, and the tools needed for the Internal Audit Department to execute its duties as defined in this Charter.

INFORMATION
ITEM
2A



Inland Empire Utilities Agency

A MUNICIPAL WATER DISTRICT

Date: March 15, 2017
To: The Honorable Board of Directors
Through: Audit Committee (3/6/2017)
From: 
Teresa V. Velarde
Manager of Internal Audit
Subject: Report on the Audit Function

RECOMMENDATION

This is an information item for the Board of Directors.

BACKGROUND

The Inland Empire Utilities Agency (IEUA or Agency) Internal Audit Department (IA) and the Audit Committee were established by Board action on April 21, 2004. The Audit Function was established as a response to increased responsibilities for financial reporting and audit compliance requirements of various regulatory agencies, specifically related to the financial growth of the Agency associated with the issuance of bonds and receipt of increasing grant funding, along with the administration of rebate programs and the active roles and projects with various joint powers and member agencies. As documented in the March 17, 2004 Board Letter, the Audit Function was the staff recommendation to provide greater Board oversight of External Auditor activities, to perform internal audits and prepare/submit audit reports, to adopt Government Finance Officers Association (GFOA) and Institute of Internal Auditors (IIA) guidance and comply with California legislation anticipated changes in audit reporting requirements. Additionally, to ensure the Agency maintains the highest standards of fiscal integrity and accountability, provide a system of sound checks and balances, and ensure a truly independent view of Agency operations.

For purposes of this report, “the Audit Function” refers to: the Internal Audit Department, the External Auditors, the Audit Committee Financial Expert and the Audit Committee. The purpose of the Audit Function is to assist the Agency in achieving its goals and objectives. The Internal Audit Department is charged with the responsibility to ensure the oversight obligations of the Audit Function are met. The Internal Audit Department seeks to add value and improve the organization’s operations through independent, objective audits, reviews and evaluations and recommendations provided. Internal Auditors must adhere to a strict Code of Conduct, professional standards and principles and follow a systematic, disciplined approach in performing internal audits, evaluating operations and making recommendations.

The current structure of the Agency's Internal Audit Department follows best practices and guidelines provided the Government Finance Officers Association (GFOA), the Institute of Internal Auditors (IIA) and the American Institute of Certified Public Accountants (AICPA). Consistent with those best practices, the Internal Audit Department reports functionally to the Board through the Audit Committee for the purpose of establishing the necessary independence and objectivity. Also, consistent with best practices, the Internal Audit Department reports administratively to the General Manager for the purpose of planning and coordinating audit projects, establishing the department's budget and staffing needs and other administrative items. The purpose, authority and responsibilities of the Internal Audit Department are documented in the Board-approved Charter.

In summary, the purpose of the Internal Audit Department is to:

- Assists the Agency achieve its goals
- Evaluates risks
- Assesses the reliability of internal controls
- Provides recommendations for improving operations
- Promotes a strong ethical culture
- Reviews processes and procedures
- Provides on-going monitoring and compliance
- Safeguards assets
- Raises potential red flags
- Communicates results to management, the Audit Committee and the Board
- Serves as the "eyes and ears" of the Board of Directors

The IEUA Audit Committee is composed of two members of the Board and an outside member that serves as the Financial Expert and Advisor to the Audit Committee, as prescribed by best practices. GFOA, AICPA and the IIA recommend the Audit Committee meet at minimum quarterly and discuss audit matters with Executive Management, the Internal Auditor, the Financial Advisor and the External Auditors and report to the Board any significant issues that warrant attention.

The attached report provides additional detail and information about the Audit Function including:

- Background and historical information
- Internal Audit Department
- External Financial Audit Firm
- Audit Committee Financial Advisor
- Audit Committee
- Types of Audits performed by IA
- The Annual Audit Plan
- Best Practices for the Audit Function as recommended by:
 - Government Finance Officers Association (GFOA)
 - Institute of Internal Auditors (IIA)
 - American Institute of Certified Public Accountants (AICPA)
- Additional Reference Material

In summary, IEUA has adopted best practices in structuring and establishing an effective Audit Function. The documents attached include a comprehensive report, and additional reference material taken from best practice guidance. Internal Audit appreciates the opportunity to provide this comprehensive report on the Audit Function and would like to request direction, feedback and/or changes for audit responsibilities.

This report evaluating the IEUA Audit Function is consistent with the Agency's Business Goals of Fiscal Responsibility, Workplace Environment and Business Practices by describing the functions, roles and responsibilities of the Internal Audit Department and providing an overview of the components which make up the Audit Function.

PRIOR BOARD ACTION

On December 21, 2016, the Board of Directors received the Audit Committee and Internal Audit Charters.

On December 16, 2015, the Board of Directors reconfirmed the amended Audit Committee and Internal Audit Charters.

On December 18, 2013, the Board of Directors approved the revised Audit Committee and Internal Audit Charters.

On December 15, 2010, the Board of Directors approved the revised Audit Committee Charter.

On December 9, 2009, the Board of Directors approved the revised Internal Department Charter.

On April 21, 2004, the Board of Directors approved the establishment of an Audit Committee of the Board of Directors, the new position of Internal Auditor, and the new position of Assistant Auditor.

IMPACT ON BUDGET

None.

Attachments

1. The Audit Function

<https://www.dropbox.com/s/g21wwtsqxnv2wxa/17010%20Binder%20-%20ALL%20DOCUMENTS.pdf?dl=0>



Inland Empire Utilities Agency

A MUNICIPAL WATER DISTRICT

The Audit Function

This report evaluating the IEUA Audit Function is consistent with the Agency's Business Goals of Fiscal Responsibility, Workplace Environment and Business Practices by describing the functions, roles and responsibilities of the Internal Audit Department and providing an overview of the components which make up the Audit Function.

Prepared by:
Internal Audit Department
March 15, 2017



Inland Empire Utilities Agency

A MUNICIPAL WATER DISTRICT

6075 Kimball Avenue • Chino, CA 91708
P.O. Box 9020 • Chino Hills, CA 91709
TEL (909) 993-1600 • FAX (909) 993-1985
www.ieua.org

DATE: March 15, 2017

TO: Honorable Board of Directors

Joseph P. Grindstaff
General Manager

Teresa V. Velarde

FROM: Teresa V. Velarde
Manager of Internal Audit

SUBJECT: The Audit Function

The Inland Empire Utilities Agency (IEUA or Agency) Internal Audit Department (IA) and the Audit Committee were established by Board action on April 21, 2004. The Audit Function was established as a response to increased responsibilities for financial reporting and audit compliance requirements of various regulatory agencies, specifically related to the financial growth of the Agency associated with the issuance of bonds and receipt of increasing grant funding, along with the administration of rebate programs and the active roles and projects with various joint powers and member agencies. As documented in the March 17, 2004 Board Letter, the Audit Function was the staff recommendation to provide greater Board oversight of External Auditor activities, to perform internal audits and prepare/submit audit reports, to adopt Government Finance Officers Association (GFOA) and Institute of Internal Auditors (IIA) guidance and comply with California legislation modifying audit reporting. Additionally, to ensure the Agency maintains the highest standards of fiscal integrity and accountability, provide a system of sound checks and balances, and ensure a truly independent view of Agency operations.

For purposes of this report, "the Audit Function" refers to: the Internal Audit Department, the External Auditors, the Audit Committee Financial Expert and the Audit Committee. The purpose of the Audit Function is to assist the Agency in achieving its goals and objectives. The Internal Audit Department is charged with the responsibility to ensure the oversight obligations of the Audit Function are met. The Internal Audit Department seeks to add value and improve the organization's operations through independent, objective audits, reviews and evaluations and recommendations provided. Internal Auditors must adhere to a strict Code of Conduct, professional standards and principles and follow a systematic, disciplined approach in performing internal audits, evaluating operations and make recommendations.

Water Smart – Thinking in Terms of Tomorrow

Steven J. Elie
President

Michael E. Camacho
Vice President

Jasmin A. Hall
Secretary/Treasurer

Paul Hofer
Director

Kati Parker
Director

P. Joseph Grindstaff
General Manager

The current structure of the Agency's Internal Audit Department follows best practices and guidelines provided the Government Finance Officers Association (GFOA), the Institute of Internal Auditors (IIA) and the American Institute of Certified Public Accountants (AICPA). Consistent with those best practices, the Internal Audit Department reports functionally to the Board through the Audit Committee to establish independence and objectivity. Also, consistent with best practices, the Internal Audit Department reports administratively to the General Manager for planning and coordinating audit projects, establishing the department's budget and staffing needs and other administrative items. The purpose, authority and responsibilities of the Internal Audit Department are documented in the Board-approved Charter.

The purpose of the Internal Audit Department is summarized as:

- Assists the Agency achieve its goals
- Evaluates risks
- Assesses the reliability of internal controls
- Provides recommendations for improving operations
- Promotes a strong ethical culture
- Reviews processes and procedures
- Provides on-going monitoring and compliance
- Safeguards assets
- Raises potential red flags
- Communicates results to management, the Audit Committee and the Board
- Serves as the "eyes and ears" of the Board of Directors

The IEUA Audit Committee is composed of two members of the Board and an outside member that serves as the Financial Expert and Advisor to the Audit Committee, as prescribed by best practices. GFOA, AICPA and the IIA recommend the Audit Committee meet at minimum quarterly and discuss audit matters with Executive Management, the Internal Auditor, the Financial Advisor and the External Auditors and report to the Board any significant issues that warrant attention.

The attached report provides additional detail and information about the Audit Function including:

- Background and historical information
- Internal Audit Department
- Audit Committee
- Audit Committee Financial Advisor
- External Financial Auditor
- Types of Audits performed by IA
- The Annual Audit Plan

- Best Practices for the Audit Function as recommended by:
 - Government Finance Officers Association (GFOA)
 - Institute of Internal Auditors (IIA)
 - American Institute of Certified Public Accountants (AICPA)
- Additional Reference Material

IEUA has adopted best practices in structuring and establishing an effective Audit Function. The report that follows provides details about the Audit Function at IEUA with greater discussion focused on the Internal Audit Department.

The documents attached are additional reference material and relevant information gathered from best practice guidance related to the Audit Function, including the following:

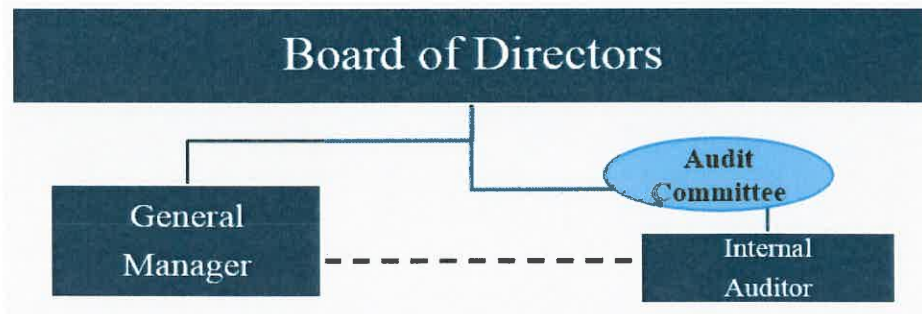
- AICPA Audit Committee Toolkit
 - A toolkit for evaluating the various resources of the Audit Committee
- The Charters: Audit Committee and Internal Audit Department Charters
- 2004 Board Letter regarding the establishment of the Audit Function
- The IIA's Guidance on the Audit Committee
- GFOAs best practice guidance/information
- AICPA's best practice guidance/information
- Association of Certified Fraud Examiner's (ACFE) Report to the Nations on Occupational Fraud and Abuse

The Internal Audit Department appreciates the opportunity to provide this comprehensive report on the Audit Function of IEUA and request direction, feedback and/or changes for the fulfillment of audit responsibilities and future Audit Committee Meetings. The Manager of Internal Audit is available to provide additional information or answer any questions.

This report evaluating the IEUA Audit Function is consistent with the Agency's Business Goals of Fiscal Responsibility, Workplace Environment and Business Practices by describing the functions, roles and responsibilities of the Internal Audit Department and providing an overview of the components which make up the Audit Function.

The Audit Function

This diagram illustrates the reporting lines of the Internal Auditor.



Background

IEUA's Internal Audit Department was established by the Agency's Board of Directors on April 21, 2004. The Board of Directors asked Agency staff to conduct research and provide recommendations on the best structure for the Internal Audit Department and the Audit Committee. Based on the research completed and recommendations by staff, the Board approved the "best practices" model suggested by the Government Finance Officers Association (GFOA), the Institute of Internal Auditors (IIA), and the Agency's General Counsel. This has remained the model since its establishment:

- An Audit Committee composed of three committee members, two members of the Board of Directors and an Audit Committee Member, with no voting rights, to serve as the Financial Expert with experience in conducting financial audits, as suggested by best practices.
- The position of Internal Auditor reporting functionally to the Board through the Audit Committee and reporting administratively to the General Manager.

According to the Board report presented in 2004, this structure was recommended and established:

"to address this increase in responsibility" (from increased auditing requirements and reporting of expenditures for special districts by the California Legislature), "to ensure administrative and financial accountability to standards required by federal and state regulatory agencies and bondholders, to better define staff's administrative responsibilities, and to provide the Board with a consistent means of monitoring the Agency's financial responsibilities".

GFOA recommends that every government consider the feasibility of establishing a formal internal audit function (GFOA recommended practice, 1997). Further, GFOA recommends the internal audit function be established formally by charter. IEUA has adopted best practices and has established the Internal Audit Department by Board-approved Charter.

The Internal Audit Department is currently staffed with one full-time Manager of Internal Audit and two full-time Senior Internal Auditors. As required by the Board-approved Charter, the Manager of Internal Audit, reports functionally to the Board through the Audit Committee, and administratively to the General Manager. This independent reporting line establishes the Internal Audit Department as a separate, independent entity to assist management in achieving organizational goals and to assist the Board in fulfilling its oversight responsibilities. This reporting line supports IA and ensures that audit work is performed objectively and independently.

The Role of the Internal Audit Department

Mission Statement

The Internal Audit Department seeks to improve the operations of the Agency by providing unbiased and objective assessments and recommendations to ensure Agency resources are efficiently and effectively managed in order to achieve Agency goals and objectives. The Internal Audit Department will help the Agency achieve its goals and objectives, improve operations, and instill confidence among its employees and the citizens it serves by providing independent, objective assurance and consulting services and provide management and the Board of Directors with recommendations to:

- *Promote and strengthen a sound control environment.*
- *Improve Agency risk management, control and governance.*
- *Promote the Agency's vision and mission through a high degree of professionalism.*
- *Establish adequate policies and procedures and to comply with them.*
- *Encourage efficient use of Agency resources.*
- *Protect and safeguard Agency assets.*
- *Mitigate risks related to fraud, waste and abuse.*
- *Hold staff accountable for the resolution of audit recommendations.*

Internal Audit Department Charter

The purpose, authority and responsibilities of the Internal Audit Department are documented in the Board-approved Charter. The Internal Audit Department Charter states that the purpose of the Internal Audit Department is to assist the Board of Directors and the Audit Committee in fulfilling their oversight responsibilities for financial reporting,

internal controls and compliance with legal and regulatory requirements applicable to Agency operations and to provide objective assurance about Agency operations. Those responsibilities are fulfilled through the various planned audit projects, discussions with Executive Management, the External Financial Auditor and the Audit Committee Financial Expert, as well as discussions with the Audit Committee. The Charter is provided for Audit Committee and Board review and/or discussion each year. The Internal Audit Department evaluates changes in best practices and suggestions by the External Financial Advisor and the External Auditor in making changes/edits to the Charters. The Charters are posted on the Internal Audit Department webpage on the Agency's intranet website.

Annual Audit Plan

The Annual Audit Plan is a flexible plan of audit projects proposed for the succeeding year. The proposed audit projects are selected based on risks considered, requests by management and inquiries of the Agency's management, External Auditors, the Audit Committee Advisor, general counsel and others. The plan is intended to provide information about the proposed scope of work for each project. The plan is meant to address risk areas and to evaluate and contribute to improving effectiveness of operations. The Annual Audit Plan is submitted for Audit Committee review and discussion Board approval in June. The current Annual Audit Plan in effect, can be found under Board-approved documents and located on the Internal Audit Department webpage on the Agency's intranet website.

Types of Audits

The Internal Audit Department performs operational audits of the various business units of the Agency. An operational audit is designed to evaluate an activity's effectiveness and efficiency of operations. IA's operational audits also incorporate elements of program, financial and compliance audits to evaluate financial transactions and overall compliance of the activity with specific requirements. Prior to finalizing an audit, discussions take place between IA and the auditee about the audit results and resulting audit findings and recommendations. Then, the auditee has opportunities to provide resolutions, responses or additional information prior to IA finalizing the audit report. Results of audits are documented in a formal audit report and discussed during Audit Committee meetings. Auditees can provide a written response and include corrective action plans. Any resulting open/outstanding audit recommendations are followed-up as scheduled through the Annual Audit Plan until full implementation is achieved or alternate controls are incorporated.

IA has completed audits in multiple areas of the Agency, including:

- Warehouse Operations
- Human Resources
- Finance & Accounting
- Inter-company Receivables
- Construction Management
- Contracts and Procurement
- Laboratory
- Environmental Compliance
- Pre-Treatment and Source Control
- Integrated Systems Services
- Vehicle Audits
- Energy/Utility Bills
- Regional Contract Audits of the 7 contracting agencies

All audit reports are discussed during the regular Audit Committee Meetings and can be accessed through the Agency Information Management (AIM), the Agency's intranet site, also available on the Internal Audit Department webpage on AIM, through the Board Reports on the main IEUA webpage or available upon request from the Manager of IA.

Standards

In performing audit work, internal auditors abide by the Code of Ethics and the *Standards* as promulgated by the Institute of Internal Auditors (IIA) as documented in the International Professional Practice Framework (IPPF) or "Red Book."

BEST PRACTICES RECOMMENDATIONS FOR INTERNAL AUDIT STRUCTURE

Government Finance Officers Association (GFOA)

- *"Every government should consider the feasibility of establishing a formal internal audit function because such a function can play an important role in helping management to maintain a comprehensive framework of internal controls. As a rule, a formal internal audit function is particularly valuable for those activities involving a high degree of risk (e.g., complex accounting systems, contracts with outside parties, a rapidly changing environment). If it is not feasible to establish a separate internal audit function, a government is encouraged to consider either 1) assigning internal audit responsibilities to its regular employees or 2) obtaining the services of an accounting firm (other than the independent auditor) for this purpose;*

- *The internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means;*
- *It is recommended that internal auditors of state and local governments conduct their work in accordance with the professional standards relevant to internal auditing contained in the U.S. General Accounting Office's publication Government Auditing Standards, including those applicable to the independence of internal auditors;*
- *At a minimum, the head of the internal audit function should possess a college degree and appropriate relevant experience. It also is highly desirable that the head of the internal audit function hold some appropriate form of professional certification (e.g., certified internal auditor, certified public accountant, certified information systems auditor) ; and*
- *All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government's audit committee or its equivalent."*

American Institute of Certified Public Accountants (AICPA)

"First and foremost, the internal audit department will understand that its responsibilities are primarily to the audit committee. A strong internal audit function may also include audit committee oversight of the internal audit group's budget approval process and its policies regarding hiring, evaluation, training, and termination of internal audit staff. Terminating or transferring high level internal audit personnel will be ultimately determined by the audit committee.

Executive sessions with the head of the internal audit function at every audit committee meeting provide the audit committee a unique opportunity to engage in candid discussions with him or her about the possible risk of management override of internal control and any indications of improper conduct by senior management.

The audit committee, by understanding and assisting in developing the internal auditors' annual audit plan, will influence the internal auditors' agenda by directing the plan's emphasis to areas of particular interest to the audit committee. These areas might include fraud risks—particularly matters that surfaced during the brainstorming session—and controls over judgments and estimates and key information processes. A properly directed internal audit staff can serve as the "eyes and ears" of the audit committee."

The Institute of Internal Auditors (IIA)

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Reporting to executive management and having direct access to the audit committee well positions the internal audit activity within an organization. Internal audit independence is furthered by periodic private meetings between the audit committee and the CAE, during which time sensitive issues are discussed without management’s presence.”

The Audit Committee

The IEUA Audit Committee structure follows recommended best practices and professional standards. The April, 2004 Board report included the following structural recommendation about the creation of an Audit Committee as a separate committee of the Board of Directors:

“An Audit Committee of the Board of Directors be established to oversee the audit and grants’ responsibilities of the current Chief Financial Officer position. The Committee would be responsible to meet at least quarterly with the Agency’s Internal Auditor and Agency staff, for overseeing the acquisition of the Agency’s outside Auditor, developing the scope of work for the annual audit, approving the annual audit work plan, directing special internal audits, reviewing and approving the internal auditing work plans, evaluating the performance of the internal audit activities, and providing policy direction to the Agency’s Audit and Grants Department. The Audit Committee would meet at least quarterly with the Internal Auditor to review work plans, audit activities and the draft/final audit reports. The Audit Committee would submit all audit management reports to the Board for review and policy direction, as appropriate.”

This recommendation was developed based upon research performed by IEUA staff. IEUA staff discussed the structure of the Audit Committee and Internal Audit Department with the “Agency’s bond counsel, investment banker, the External Auditor, The Agency’s General Counsel, and the Metropolitan Water District’s Chief Financial Officer who suggested the proposed reorganization was in the best interests of the Agency.”

The Audit Committee meets quarterly and is comprised of three members: two Board Members and one External Financial Expert. The Manager of IA is responsible for preparing all agenda items for the Audit Committee meetings.

Audit Committee Charter

The Audit Committee Charter documents the purpose, composition, authority and responsibility of the Audit Committee. The Charter is reviewed and discussed annually and any changes must be approved by the Board. The Charter follows best practice recommendations by GFOA, IIA and AICPA. The Charter also states that the Audit Committee shall delegate fulfilling those responsibilities to the Internal Audit Department. Those responsibilities are fulfilled through various evaluations and discussions with Executive Management, the Internal Auditor, the External Auditor and the Audit Committee Financial Advisor.

BEST PRACTICES RECOMMENDATIONS FOR AUDIT COMMITTEE STRUCTURE

Government Finance Officers Association

- *“The governing body of every state and local government should establish an audit committee or its equivalent.*
- *The audit committee should be . . . made directly responsible for the appointment, compensation, retention, and oversight of the work of any independent accountants engaged for the purpose of preparing or issuing an independent audit report or performing other independent audit, review, or attest services.*
- *All members of the audit committee should be members of the governing body.*
- *It is the responsibility of the audit committee to provide independent review and oversight of a government’s financial reporting processes, internal controls and independent auditors.*
- *The audit committee should have access to the reports of internal auditors, as well as access to annual internal audit work plans.”*

American Institute of Certified Public Accountants

“Government entities are faced with ongoing challenges related to the governance of their organization, risks associated with achieving their organization’s objectives, and compliance with revised and emerging laws and regulations. Responsibilities are ultimately identified by the governing body and assigned to various governing committees, including the audit committee . . .

The audit committee assists the governing body in its oversight of

- *integrity of the organization’s financial statements;*
- *internal control including internal control over financial reporting;*
- *independent auditor’s qualifications, independence, and performance;*

- *internal audit function's qualifications, independence, and performance;*
- *the organization's risk management and overall governance process; and*
- *the organization's ethics and compliance program, which includes legal and regulatory requirements."*

The Institute of Internal Auditors

"The cornerstones of effective governance are the board of directors, executive management, the internal auditors, and the external auditors. No single committee of the board is more focused on or better in tune with governance than the audit committee.

What is the audit committee's role in governance? In a nutshell, the audit committee should provide oversight of financial reporting, risk management, internal control, compliance, ethics, management, internal auditors, and the external auditors.

Some detailed audit committee responsibilities include:

- *Ensuring that financial statements are understandable, transparent, and reliable.*
- *Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.*
- *Helping achieve an organization-wide commitment to strong and effective internal controls, emanating from the tone at the top.*
- *Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, and the investigation of misconduct and fraud.*
- *Reviewing current and pending corporate-governance-related litigation or regulatory proceedings to which the organization is a party.*
- *Continually communicating with senior management regarding status, progress, and new developments, as well as problematic areas.*
- *Ensuring the internal auditors' access to the audit committee, encouraging communication beyond scheduled committee meetings.*
- *Reviewing internal audit plans, reports, and significant findings.*
- *Establishing a direct reporting relationship with the external auditors."*

Role of the Financial Expert

The April, 2004 recommendation that established the Audit Committee and the Internal Audit Department did not discuss the role of an external financial expert in providing counsel and advice to the Audit Committee. The Audit Committee Advisor/Financial Expert serves as a resource to the Audit Committee, the Internal Audit Department and Executive Management. The Financial Advisor serves as a checks and balance for the Internal Audit Department for the Audit Committee and serves as an interpreter for the Audit Committee. Professional best practices provide the following:

BEST PRACTICES RECOMMENDATIONS FOR AUDIT COMMITTEE FINANCIAL EXPERT

Government Finance Officers Association

"The audit committee also should have access to the services of at least one financial expert, either a committee member or an outside party engaged by the committee for this purpose. Such a financial expert should through both education and experience, and in a manner specifically relevant to the government sector, possess 1) an understanding of generally accepted accounting principles and financial statements; 2) experience in preparing or auditing financial statements of comparable entities; 3) experience in applying such principles in connection with the accounting for estimates, accruals, and reserves; 4) experience with internal accounting controls; and 5) an understanding of audit committee functions"

American Institute of Certified Public Accountants

"If no individual member of the audit committee possesses the attributes required for financial expertise, and the committee members collectively do not possess such attributes, two options might be considered:

- *Engage a financial professional to provide financial expertise as a consultant to the audit committee. Such an individual must otherwise be independent with respect to the entity (that is, must have no other financial arrangements with the government entity).*
- *Pursue a training program for audit committee members to develop the financial expertise. Such training can include participation in professional development classes or programs offered by the AICPA, associations, or the specific sector in which the government entity participates, or in-house training programs led by members of the government entity's financial management team."*

The Institute of Internal Auditors

"The audit committee charter should define membership requirements, include a provision for a financial expert, allow for yearly reviews and changes . . . "

IEUA has contracted with Travis C. Hickey, CPA consultant with Rogers, Anderson, Malody, and Scott, LLP to be the Audit Committee Advisor. Over the past nine years, Mr. Hickey has been a valuable resource to the Audit Committee and the Internal Audit Department by providing consulting and advisory services, along with professional audit advice and information.

Role of the External Financial Auditor

State law and the Agency's Fiscal Ordinance requires that an independent certified public accountant audit the Financial Statements of the Agency. The purpose of a financial audit is to demonstrate that the Agency's financial statements were prepared in conformity with generally accepted accounting principles in the United States of America (GAAP), as set forth by the Governmental Accounting Standards Board (GASB). Responsibility for both the accuracy of the presented data, and the completeness and fairness of the presentation, including all disclosures, rests with the management of the Agency. The role of the External Auditors is also to evaluate the adequacy and accuracy of the accounts, test internal controls and complete the audit in accordance with generally accepted auditing standards. The auditors are only providing an opinion as to the representations provided by the Agency. The purpose of the annual financial audit is to receive an independent audit opinion as to the fairness of the financial statements. The opinion is relied upon by readers of the financial statements such as lenders, rating agencies and other stakeholders. The scope of the audit and the materiality threshold set for the audit testing and procedures are determined based on the auditor's risk assessment, professional guidelines and their professional judgment. The audit is not meant to detect fraud. The External Financial Auditors must be licensed as Certified Public Accountants in the State of California and follow a rigorous set of guidelines established by the American Institute of Certified Public Accountants for the performance of financial audits. The Agency currently has a contract with Lance, Soll & Lunghard, LLP, located in Brea, CA for financial auditing and single audit services.

Charters

The professional standards describe two separate charters that provide guidance to the Internal Audit function. One is the Internal Audit Department's charter that defines the activity's purpose and the other is the Audit Committee's charter which provides information about the Committee's governance responsibilities, goals and purpose. IEUA follows best practices and has adopted both Charters for the IAD and the Audit Committee.

Internal Audit Department Charter

The IPPF Standards states that “the internal audit activity must be formally defined in an internal audit charter, consistent with the “Mission of Internal Audit and the mandatory elements of the Framework”. The IPPF Standards clarify this responsibility by stating:

“The internal audit charter is a formal document that defines the internal audit activity’s purpose, authority and responsibility. The internal audit charter establishes the internal audit activity’s position within the organization, reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.”

BEST PRACTICES RECOMMENDATIONS FOR INTERNAL AUDIT CHARTER

Government Finance Officers Association

“The internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means.”

American Institute of Certified Public Accountants

The AICPA also recommends that one aspect of the audit committee’s oversight responsibilities for Internal Audit includes: *“Approve the internal audit department charter.”*

Audit Committee Charter

BEST PRACTICES RECOMMENDATIONS FOR AUDIT COMMITTEE CHARTER

Government Finance Officers Association

“The audit committee should be formally established by charter, enabling resolution or other appropriate legal means and . . . the written documentation establishing the audit committee should proscribe the scope of the committee’s responsibilities, as well as its structure, processes, and membership requirements. The audit committee should itself periodically review such documentation, no less than once every five years, to assess its continued adequacy.”

American Institute of Certified Public Accountants

“Specific responsibilities assigned to an audit committee are set forth in an audit committee charter . . . that is approved by the governing body. An audit committee charter should address the audit committee process, procedures, and responsibilities. Audit committee responsibilities can vary by government entity due to factors such as size of the entity, the type of entity, and the complexity of the government entity’s service or business model.”

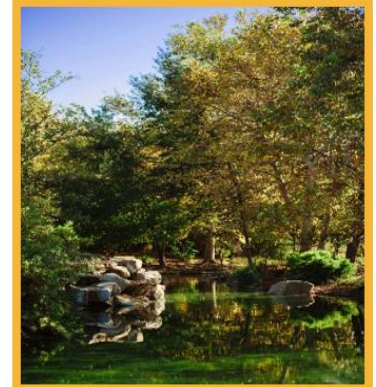
American Institute of Certified Public Accountants

“The audit committee’s charter is its blueprint for operations. Highly customized to best meet the needs of an organization’s industry, mission, and culture, the charter should clearly delineate audit committee processes, procedures, and responsibilities that have been sanctioned by the entire board.”

The document goes on to provide specific recommendations for what to include in an Audit Committee Charter and provides a sample document for reference.

The Internal Audit Department appreciates the opportunity to provide this comprehensive report on the Audit Function of IEUA.

The Audit Function at Inland Empire Utilities Agency



**The Audit Function
at
Inland Empire Utilities Agency
Report and Reference Material**

Charters: Audit Committee & Internal Audit Department
Background/History: <ul style="list-style-type: none">• 2004 Board Letter & Report (IA Committee & Department Information)
Institute of Internal Auditors (IIA): Guidance <ul style="list-style-type: none">• The Audit Committee: Purpose, Process, Professionalism• The Audit Committee: Internal Audit Oversight International Standards for the Professional Practice of Internal Auditing (Standards)
Government Finance Officers Association (GFOA) Guidance: <ul style="list-style-type: none">• Best Practice – Audit Committee• Establishing an Internal Audit Function
American Institute of Certified Public Accountants (AICPA) Guidance: <ul style="list-style-type: none">• 10 Key Internal Audit Topics for Audit Committee Consideration• Management Override of Internal Control: The Achilles' Heel of Fraud Prevention
Association of Certified Fraud Examiners (ACFE): <ul style="list-style-type: none">• 2016 Report to the Nations on Occupational Fraud and Abuse
AICPA Audit Committee Toolkit

Charters

(Audit Committee and Internal Audit Department)



INLAND EMPIRE UTILITIES AGENCY
Audit Committee Charter
Reconfirmed on March 15, 2017

PURPOSE

The Audit Committee (Committee) is established under the authority of the Inland Empire Utilities Agency (IEUA or Agency) Board of Directors (Board) and reports directly to the Board. The primary purpose of the Committee is to assist the Board in fulfilling their oversight responsibilities for financial reporting, internal controls, and compliance with legal and regulatory requirements applicable to Agency operations.

While assisting the Board with these fiduciary duties, the Committee also provides an open avenue of communication between the Board, IEUA Management, the Internal Audit Department, and the external auditors. This advisory and oversight link provides the following benefits to the organization and stakeholders:

- Increased objectivity and credibility of financial reports.
- Increased management accountability.
- Support for measures to improve management performance and internal controls.
- Increased employee awareness of unethical, questionable, or illegal activities.
- Enhanced independence and effectiveness of the Internal Audit Department.
- Assurance that appropriate management action plans are implemented for audit findings and recommendations.

COMPOSITION, COMPENSATION & TERM OF SERVICE

The Committee shall consist of two members from the Board of Directors, each with equal voting rights, with one selected as the Committee Chairperson. The members will be appointed by the Board President.

The Audit Committee shall have access to at least one financial expert, an outside party with no voting rights, who will provide advisory and consulting duties and shall be compensated as agreed upon, in writing with the audit committee, the Board, Agency management and its designees.

All members of the Audit Committee shall possess or obtain a basic understanding of governmental financial reporting, accounting and auditing and shall have a requisite interest in financial reporting issues of the Agency. The financial expert shall be an individual with sufficient financial experience and interest to provide guidance and assistance to the Audit Committee. The financial expert should through both education and experience, and in a manner specifically relevant to the government sector, possess: 1) an understanding of generally accepted accounting principles and financial statements; 2) experience in preparing or auditing financial statements of comparable entities; 3) experience in applying such principles in connection with the accounting for estimates, accruals, and reserves; 4) experience with internal accounting controls; and 5) an understanding of Audit Committee functions.

INLAND EMPIRE UTILITIES AGENCY
Audit Committee Charter
Reconfirmed on March 15, 2017

The members of the Board serving on the Audit Committee shall be compensated in accordance with the guidelines established for the IEUA Board of Directors in Ordinance No. 98 adopted May 21, 2014, and as amended from time to time, entitled:

"Ordinance of the Inland Empire Utilities Agency, a Municipal Water District, San Bernardino County, California, establishing compensation/benefits and authorizing reimbursement of expenses for the Board of Directors and their appointed representatives to the Metropolitan Water District of Southern California Board of Directors and outside Committee Members."

The service term for each Committee member will be two years. Prior to term expiration, the Board President or their designee will conduct a review of Board Committee members' eligibility and the Board of Directors will conduct a review of the external/outside Committee member's eligibility. The Board President will then reconfirm the Committee members or select and confirm new members as needed. All activities and actions pertaining to selection or reconfirmation of Committee members will be documented by the Board, or their designee, and recorded in the next regularly scheduled IEUA Board of Directors' meeting minutes.

AUTHORITY

The Audit Committee has unrestricted access to all information and records, including IEUA personnel and documents. The Committee will have adequate resources to fulfill its oversight responsibilities, including the right to seek independent professional advice and counsel. The Committee is empowered to:

- Meet, as deemed appropriate and necessary, with IEUA Management and employees, the Manager of Internal Audit and audit staff, external auditors and legal counsel.
- Recommend to the Board the approval of the Internal Audit Department's Annual Audit Plan and any changes to the Plan or the Manager of Internal Audit duties.
- Authorize special audits and investigations into any matters within its scope of responsibility.
- Authorize an internal audit or review of any department or function under the control of the Board of Directors, or within the scope of influence of the IEUA.
- Recommend to the Board the appointment, compensation and scope of work of any public accounting firm employed by the IEUA.
- Recommend to the Board the approval of any auditing and consulting services.

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- Review and recommend to the Board the external auditor's audit scope and approach, ensuring that the scope:
 1. Is in compliance with Generally Accepted Auditing Standards (issued by the American Institute of Certified Public Accountants).
 2. Is in compliance with Government Auditing Standards (issued by the Government Accountability Office).
 3. Will include a Single Audit that will be performed, if required, subject to the Office of Management and Budget (OMB) Circular A-133.
 4. Will include an opinion on each major fund presented in the Agency's financial statements.
- Review and recommend to the Board the approval of external auditors' reports, along with Management's written responses, when appropriate.
- Resolve any disagreements between Management, the Internal Audit Department, and the external auditors regarding financial or operational controls and reporting.
- Ensure corrective action is taken on internal accounting control weaknesses identified by the internal and external auditors.

RESPONSIBILITIES

The Audit Committee is chartered with performing oversight for the Board of Directors. In addition to reviewing this Charter annually and updating it as needed, the Committee has responsibilities in the areas of Financial Reporting, Internal Controls, the Internal Audit Department, the External Audit and external auditors, Compliance requirements, and Other Matters as provided in the following sections. The Committee has the overall responsibility to ensure the general requirements underlying these items are carried out. However, the Audit Committee has the flexibility and authority to determine and choose the best course of action and the best method for carrying out its responsibilities. The following items are best practice guidelines that may be employed:

Financial Reporting:

- Review annual financial statements and consider whether they are complete, consistent with information known to Committee members, and reflect appropriate accounting principles.
- Advise the Board and management of any situations that would cause the Committee to believe the audited financial statements may contain material misstatements or omissions.
- Inquire of the General Manager and Chief Financial Officer (CFO) regarding the fiscal health of the Agency as well as the financial status of the Agency in relation to its adopted budget.
- Inquire of management, the Manager of Internal Audit, and the external auditors about whether significant financial, managerial, and operational information is accurate, reliable, complete, and timely.
- Inquire of Agency management, the Manager of Internal Audit, and the external auditors about significant risks or exposures facing the Agency; assess the steps management has

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taken or proposes to take to minimize such risks to the Agency; and periodically review compliance with such steps.

Internal Controls:

- Discuss with Agency management, the Manager of Internal Audit, and the external auditors the reliability and effectiveness of the Agency's internal control environment to mitigate risk, including information technology security and control.
- Discuss with Agency management, the effectiveness of the Agency's process for identifying and assessing significant risks and exposures, and the steps Agency management has taken to communicate, monitor and mitigate these risks.
- Understand the scope of the internal and external auditors' reviews of internal controls, and obtain and review reports of significant findings, recommendations, and Agency management's action plans to mitigate risks.
- Review all significant accounting policy changes submitted by Agency management with the Internal Audit Department, and/or the external auditors, and provide recommendations to the Board and Agency management.
- Periodically review Agency policies and procedures governing Board of Director and employee conduct, including conflict of interest, misconduct, fraud and other sensitive issues or non-compliance and recommend changes to the Board and Agency management as appropriate.
- Discuss with Agency management, the Manager of Internal Audit, and the external auditors whether adequate policies have been established and the Agency complies with policies, standards and applicable laws and regulations.
- Discuss with Agency management, the Manager of Internal Audit, and the external auditors whether significant legislative or regulatory issues impacting Agency operations are identified, recognized, communicated and appropriately addressed.
- Review with Agency management, the Manager of Internal Audit, and the external auditors the audit scope and plan of the Internal Audit Department and the external auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.
- Review with Agency management and the Manager of Internal Audit:
 - Significant findings, recommendations, and management's responses thereto.
 - Any difficulties the Internal Audit Department encountered in the course of their audits, including any restrictions on the scope of their work or access to required information.
 - Any changes required in the scope of their internal audits.
 - The Internal Audit Department budget and staffing.
 - The Internal Audit Department Charter.
 - The Internal Audit Department's compliance with applicable standards (for example, Governmental Auditing Standards, or the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing).

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- Periodically review the Agency's Code of Conduct/Ethics Policy to ensure that it is adequate and up to date.
- Review with the Manager of Internal Audit and the Agency's general counsel the results of their reviews of compliance monitoring with the Code of Conduct/Ethics Policy.
- Review the procedures for the receipt, retention, and treatment of complaints received by the Agency regarding accounting, internal accounting controls, auditing matters, or suspected fraud that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, the current status, and resolution if one has been reached.
- Review procedures for the confidential, anonymous submission by Agency employees of concerns regarding questionable accounting or auditing matters, or suspected fraud. Review any submissions that have been received, the current status, and the resolution if one has been reached.
- Inquire of Agency management, the Manager of Internal Audit, and the external auditors about significant risks or exposures facing the Agency. Assess the steps management has taken or proposes to take to communicate, manage, and minimize such risks to the Agency; and periodically review compliance with such steps.
- Review with the Manager of Internal Audit, and the external auditors:
 - The adequacy of the Agency's internal controls including computerized information system controls and security.
 - Any significant findings and recommendations of the Manager of Internal Audit, and the external auditors together with management's responses thereto.

Internal Audit Department:

- Request that the Agency's Manager of Internal Audit prepare the Audit Committee's meeting agendas designed to ensure that all of the responsibilities of the Audit Committee as described herein are addressed at least once a year.
- Ensure there are no unjustified restrictions or limitations placed on the Internal Audit Department.
- Review with the Board, General Manager, and the Manager of Internal Audit the Internal Audit Department Charter, Annual Audit Plan, staffing, budget, and organizational reporting structure to ensure they meet the Committee's goals, objectives, and responsibilities to the Board and Agency management.
- Review and recommend to the Board the approval of the Internal Audit Department's Annual Audit Plan and any significant changes that may occur during the year.
- Review, as needed, all internal audit reports, findings, and recommendations.
- Review and recommend to the Board the appointment, replacement, dismissal, or change in duties of the Manager of Internal Audit.
- Review the effectiveness of the Internal Audit Department's function, including compliance with The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing (Standards)*.

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- Conduct the Manager of Internal Audit performance appraisals and recommend Manager of Internal Audit merit increases and incentive compensation to the Board.
- Hold management accountable for the appropriate resolution of Internal Audit Department's recommendations and ensure that disposition has been determined for Audit Department recommendations from the prior year. If management has determined that Internal Audit Department recommendations need not be implemented because of adequate compensating controls, based upon a cost/benefit analysis or because the risks are at an acceptable level in accordance with the Agency's goals and objectives, evaluate the reasonableness of such determinations and advise the Board of Directors accordingly.

External Audit:

- Review the external accounting firm's proposals and fee structure, and provide recommendations and external audit plan approval to the Board.
- Review the external auditors' proposed audit scope and approach to ensure emphasis is placed on areas the Committee, Board, Management and external auditors believe special attention is warranted and that efforts are coordinated with the Internal Audit Department.
- Evaluate the external auditor's independence, and if needed, recommend the Board take the appropriate action to satisfy the Agency with the external auditor's independence.
- Review the effectiveness of the external auditor's work and provide the Board with the final approval to continue or discharge the current firm.
- Communicate to the external auditors areas of internal control with a heightened risk of fraud or error, any known or suspected employee fraud, management fraud, pressures or incentives for management to distort reported financial results, or any known or suspected accounting errors or misstatements.
- Communicate to the external auditors any areas of concern applicable to the external auditors' scope of responsibility (fraud, errors, or misstatements involving amounts significant to the financial statements taken as a whole).
- Review all significant written communications between the external auditors and management, such as any management letter comments or schedule of unadjusted differences (i.e. management letter, schedule of audit, or significant unusual or non-routine items, etc.)
- Hold management accountable for the appropriate resolution of external auditor recommendations, ensure that disposition has been determined for auditor recommendations from the prior year, and where management has determined that auditor recommendations need not be implemented because of adequate compensating controls or based upon a cost/benefit analysis, evaluate the reasonableness of such determinations and advise the Board of Directors accordingly.
- Review with the external auditor that performs the financial statement audit:
 - All critical accounting policies and practices used by the Agency.
 - All alternative treatments of financial information within generally accepted accounting principles that have been discussed with the Agency's management, the ramifications of each alternative, and the treatment preferred by the Agency.

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- Review with management and the external auditors:
 - The Agency's annual financial statements, related notes, and management's discussion and analysis.
 - The external auditors' audit of the financial statements and their report thereon.
 - The external auditors' judgments about the quality, not just the acceptability, of the Agency's accounting principles as applied in its financial reporting.
 - The external auditors' single audit of the federal awards administered by the Agency and their reports thereon.
 - Any significant changes required in the external auditors' audit plan.
 - Any serious difficulties or disputes with management encountered during the audit.
 - Matters required by Statement on Auditing Standards (SAS) No. 114, The Auditor's Communication With Those Charged With Governance; U.S. Government Accountability Office's (GAO) Government Auditing Standards; and the U.S. Office of Management and Budget's Circular A-133 related to the conduct of the audits.

- Evaluate whether or not the performance of any extra work or special projects requested of the Agency's external audit firm violates the independence standards of the GAO.

- Recommend that the Board of Directors approve the Agency's annual financial report, if the Committee believes that they are fairly presented, to the extent such a determination can be made on the basis of reading the financial statements and discussions with Agency management and the external auditors.

Compliance:

- Review with management and the external auditors the Agency's internal controls for identifying laws and regulations affecting operations, risks for non-compliance including litigation and fines, and implementing controls to prevent recurrence.
- Review the reports, findings and recommendations of any audits or examinations performed by external agencies.
- Review with Agency counsel any legal, tax, or regulatory matters that may have a material impact on the Agency's operations and its financial statements.

Other Matters:

- The Audit Committee shall engage consultants, specialists, or other audit firms as necessary to assist the committee in the discharging of its responsibilities.
- The Audit Committee shall direct the Manager of Internal Audit to review the Agency's Audit Committee Charter annually in order to advise the Audit Committee as to needed or recommended changes.

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- The Audit Committee shall report to the Board of Directors issues discussed in the Audit Committee meeting that, in the judgment of the committee, warrant communication to the Board to help the Board fulfill its oversight responsibility.

ETHICAL CONDUCT

Audit Committee members are prohibited from participating in any event or matter that would create, or appear to create, a conflict of interest. These activities may include having a significant financial interest or operational influence in vendors, contractors, customers or competitors of IEUA. Any activity creating an actual or apparent conflict should be immediately reported to the Audit Committee Chair and the Board of Directors for resolution.

MEETINGS

The Audit Committee shall meet no less than quarterly.

The Manager of Internal Audit will schedule and coordinate all quarterly Committee meetings, and will call additional meetings if requested to do so by any Committee member, the Board, the General Manager or the external auditors. The Manager of Internal Audit will provide all Committee members with written notification and an agenda at least 72 hours before the scheduled quarterly meetings or as soon as reasonably possible for any special meetings, all in accordance with the requirements of the Brown Act.

The General Manager and Manager of Internal Audit will be provided written notification and an agenda at least 72 hours before quarterly and special Committee meetings. These parties will be provided an opportunity to attend and speak at all Committee meetings but are not considered members of the Committee and have no voting rights.

The Board or the General Manager will provide administrative support to the Audit Committee and its meetings, including agenda preparation, participant notification, and documentation of meeting minutes.

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PURPOSE

This Charter establishes the authority and responsibilities of the Inland Empire Utilities Agency (IEUA or Agency) Internal Audit Department.

The purpose of the Internal Audit Department (Internal Audit or IA) is to assist the Board of Directors (Board) and the Audit Committee (Committee) in fulfilling their oversight responsibilities for financial reporting, internal controls, and compliance with legal and regulatory requirements applicable to Agency operations and to provide objective assurance about the Agency's operations. The purpose of the Internal Audit Department is also to provide as a service to management and as a way of adding value to improve the operations of the Agency, consulting services, analyses, recommendations, and information concerning operations.

The Internal Audit Department reports to the Board through the Committee and is an independent function from management. The responsibilities of the Internal Audit Department are defined in this Charter.

MISSION

The Internal Audit Department seeks to improve the operations of the Agency by providing unbiased and objective assessments and recommendations to ensure Agency resources are efficiently and effectively managed in order to achieve Agency goals and objectives. The Internal Audit Department will help the Agency achieve its goals and objectives, improve operations, and instill confidence among its employees and the citizens it serves by providing independent, objective assurance and consulting services and provide management and the Board of Directors with recommendations to:

- Promote and strengthen a sound control environment.
- Improve Agency risk management, control and governance.
- Promote the Agency's vision and mission through a high degree of professionalism.
- Establish adequate policies and procedures and to comply with them.
- Encourage efficient use of Agency resources.
- Protect and safeguard Agency assets.
- Mitigate risks related to fraud, waste and abuse.
- Hold staff accountable for the resolution of audit recommendations.

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VALUES

The Internal Audit Department has adopted the following value statements that form the foundation for the Internal Audit Department.

Independence

As documented in this Charter, the Internal Audit Department is an independent function of the Agency for the purpose of providing independent, objective, unbiased opinions.

Integrity

The Internal Audit Department staff is required to maintain the highest degree of integrity in conducting its audit work.

Professionalism

The Internal Audit Department will perform its work with due professional care at all times.

Collaboration

The Internal Audit Department will foster collaboration with all Agency personnel to promote teamwork within the various business units.

ACCOUNTABILITY

The Internal Auditor is the Manager of the Internal Audit Department. The Internal Auditor is accountable and reports to the Board of Directors, through the Audit Committee appointed by the Board. The intent of this reporting relationship is to establish the Internal Audit Department's independence to function effectively and in accordance with best practices.

Annually, the Internal Auditor will submit an Audit Plan for the following fiscal year to the Committee for review and approval by the Board. Quarterly status reports of significant Internal Audit activities shall be presented at Committee meetings and shall include a status of major activities and any changes or deviations from the approved audit plan. The Internal Auditor has the authority to deviate from the approved annual Audit Plan, when necessary and if warranted by unforeseen issues that require immediate attention. Significant changes to the annual Audit Plan shall be reported to the Committee and to the Board.

Annually, a listing of audit recommendations provided by the Internal Audit Department and the corresponding corrective actions taken by Agency management will be presented to the Committee.

The Internal Auditor shall inform the Committee on the sufficiency of department staffing and resources.

Annually, the Internal Audit Department must also ensure the Committee fulfills their responsibilities as required under the Audit Committee Charter. Additionally, IA must ensure the

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Internal Audit Department Charter and the Audit Committee Charter are reviewed annually and updated as necessary.

INDEPENDENCE

Independence is essential to the effectiveness of internal auditing and is strongly emphasized by the Institute of Internal Auditors (IIA), the American Institute of Certified Public Accountants (AICPA), and the U. S. General Accountability Office (GAO). The Internal Audit Department should be free, both in fact and appearance, from impairments to independence.

The Internal Auditor and the Internal Audit Department shall have no direct responsibility or authority over the day-to-day operations of the Agency or any activities they would audit. The Internal Audit Department shall not engage in any activities that would compromise their independence or would appear to be a conflict of interest.

To ensure independence is maintained, the Internal Audit Department shall report administratively to the Agency's General Manager or his designee and functionally to the Board through the Audit Committee, as stated under "Accountability".

AUTHORITY

The Internal Audit Department's authority is derived from the direction of management and the Agency's Board through the Committee as set forth in this Charter. Specifically, the Internal Audit Department is authorized to:

- Audit all areas of the Agency's operations. Perform audits of the Regional Sewage Service Contract agreement between the Agency and the Regional Contracting Agencies (RCA), including performing necessary audit field work and review of required supporting information and documents of the RCA's.
- Have unrestricted access to all Agency functions, records, information, property, and personnel.
- Have full and free access to Agency management, the Board of Directors and the Audit Committee.
- Allocate resources, set frequencies, select subjects and set objectives, determine the scope of work, and apply the techniques required to accomplish audit objectives, without interference from management.
- Obtain the necessary assistance of Agency staff where Internal Audit performs audits, as well as other specialized services from within or outside the organization.
- Obtain regular updates from management and Agency legal counsel regarding compliance matters affecting operations.

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- Establish procedures for the receipt, retention, and treatment of comments or complaints received regarding Agency accounting, operations, or internal controls, including those matters received through Ethics Point or other channels.
- Investigate and make recommendations to the Board, Audit Committee, Executive Management and/or Human Resources, as appropriate about reported instances of inappropriate activities, misappropriation of funds or fraud, including those matters received through Ethics Point or other channels.
- Obtain additional internal or external resources when the Internal Audit Department does not possess all the necessary skills or experience to complete an audit or review, subject to the approval of the Audit Committee and when necessary from the Board.

The Internal Auditor and the Internal Audit Department staff are **not** authorized to:

- Have any responsibilities or authority for any of the activities they audit or perform any operational duties for the Agency or its affiliates.
- Initiate or approve accounting transactions external to the Internal Audit Department.
- Direct the activities of any organization employee not employed by the Internal Audit Department, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the Internal Auditor in audit activities.
- Participate in any activities that would compromise their objectivity and independence or any activities that would appear to be a conflict of interest.
- Draft or write any Agency Policies and Procedures, or Standard Operating Procedures outside the Internal Audit Department.

RESPONSIBILITIES

The responsibilities of the Internal Audit Department consist of the examination, review and evaluation of the reliability and effectiveness of the Agency's governance, risk management, internal controls, and the quality of operations and systems utilized in carrying out the Agency's goals and objectives. The Internal Audit Department has the responsibility to perform its work with due professional care.

The Internal Auditor and audit staff shall be responsible for, but not limited to, incorporating periodically, as deemed necessary and/or in agreement with the annual audit plan, activities in the following key areas:

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Internal Controls

- Assess the adequacy of internal controls in place and determine if they are operating effectively.
- Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
- Review compliance with Agency policies and procedures, and with applicable laws and regulations which could have a significant impact on the operations of the Agency.
- Evaluate the means implemented and the extent Agency assets are identified, tracked, and safeguarded against misuse, unauthorized use, theft and loss.
- Review operations, programs or projects to determine if results are consistent with established objectives and goals.
- Assess the efficient and effective use of Agency resources and the controls over those resources.
- Provide consulting services on current and proposed policies, procedures, and systems to ensure adequate internal controls are considered and maintained.
- Provide consulting services to evaluate contractual agreements and determine if compliance exists.
- Use documents and information obtained from Departments in the same prudent manner as by those employees who are normally accountable for them.
- Perform “Follow-up Procedures” on all management responses to audit findings and recommendations to determine if internal control improvements and/or corrective actions have been implemented.
- Perform “Follow-up Procedures” on known external auditor’s or regulatory agency’s reported findings and recommendations to determine if internal control improvements and/or corrective actions have been implemented.
- Conduct special projects, studies, or audits as requested by management, the Audit Committee and the Board of Directors.
- Ensure known or suspected acts of fraud or improprieties involving Agency funds, property and employees are investigated in coordination with the Agency’s legal counsel, Human Resources and senior management.

Audit

- Conduct work in accordance with the *International Standards for the Professional Practice of Internal Auditing (Standards)* and Code of Ethics as required by the Institute of Internal Auditors (IIA).
- Develop a comprehensive and flexible annual audit plan using an appropriate risk-based methodology, including consideration of any risks or control concerns identified by management, the Audit Committee, the Board or the external auditor and submit that plan, as well as any periodic updates, to the Audit Committee and the Board for review and approval.
- Implement the annual audit plan, as approved, including as appropriate, any special tasks or projects requested by management, the Audit Committee, or the Board.

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- Provide Agency management with reasonable notice of intent to audit and with information about the audit process, except in those situations that warrant an unannounced audit.
- Consider the scope of work of the external auditors for the purpose of providing optimal audit coverage, at a reasonable cost, without redundancy or omission.
- Perform advisory services to assist the Agency in achieving its objectives; for example, reviewing controls, systems or process designs prior to implementation and providing recommendations to improve and enhance the effectiveness of controls and operations.
- Maintain a professional audit staff with sufficient knowledge, skills, experience, and professional certifications to meet the requirements of this Charter.
- Maintain technical competence through continuing education supported by Department goals and budgets.
- Maintain a quality assurance program whereby the Internal Auditor assures the operations of the Internal Audit Department.
- Perform a periodic review of the Internal Audit Department Charter and the Audit Committee Charter. Additions, deletions, or other changes to the Charters are subject to the approval of the Board of Directors.

Reporting

- Issue quarterly reports to and meet with the Audit Committee and management to summarize results of audit activities and status of findings and recommendations.
- Provide written status reports of Audit Department activity to the Audit Committee quarterly. The Quarterly Audit Committee Status Report will include a summary of significant internal and external audit activities for the reporting period. The Status Report will be submitted for approval by the Committee and the approved Status Report will be presented at the next regularly scheduled IEUA Board of Directors meeting.
- Provide a written report listing all outstanding recommendations with expected resolution dates annually. The report of all outstanding recommendations will be submitted for approval by the Audit Committee and provided at the next regularly scheduled IEUA Board of Directors meeting.
- Keep the Audit Committee informed of emerging trends and successful practices in internal auditing, as well as new audit requirements, when applicable.
- Immediately report any reservations concerning control risks, accounting or disclosure practices to the Audit Committee.
- If during the scope and progress of its reviews and audits, the Internal Audit Department identifies opportunities for improving the Agency's control environment, processes and procedures to ensure an environment where assets are safeguarded, internal controls are in place and risk is mitigated, these recommendations will be communicated to the appropriate level of management and the Audit Committee as timely as necessary and in the written report.
- When deemed appropriate and necessary, provide responsible unit management with a preliminary written report of the results and recommendations of each audit, analysis, review, or investigation performed and sufficient time to respond in writing with a plan of

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corrective actions. Sufficient time to reply would be 30 to 60 days from the date of the final report.

- Provide final reports of results and recommendations for each review and audit performed, including the responsible management's responses to the Audit Committee, Executive management and responsible management. All final reports with any responses will be submitted to the Committee for discussion and to the Board for approval. However, in cases where the auditee does not provide a response that is timely or deemed responsive, the final report will not be held up pending a response and will be submitted for discussion during the next scheduled Audit Committee meeting.

STANDARDS OF ETHICAL CONDUCT

The Internal Audit Department staff have a responsibility to govern themselves so that their independence is not open to question. To this end, adherence to the Institute of Internal Auditor's "Code of Ethics" will ensure integrity, objectivity, confidentiality and competency in Internal Audit work performed on behalf of the Agency's Board and Audit Committee. These principles include:

- Performing internal auditing services in accordance with the *International Standards for the Professional Practice of Internal Auditing (Standards)*.
- Exercising honesty, diligence, and responsibility in performing duties.
- Observing the law and making disclosures expected by the law and the profession.
- Not knowingly being a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the Agency.
- Respect and contribute to the legitimate and ethical objectives of the Agency.
- Not participating in any activity or relationship that may impair, or be presumed to impair, unbiased assessments, including activities or relationships that may be in conflict with the interests of the Agency.
- Not accepting anything that may impair or be presumed to impair professional judgment.
- Disclosing all material facts known that, if not disclosed, may distort the reporting of activities under review.
- Being prudent in the use and protection of information acquired in the course of duties.
- Not using information for personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the Agency.
- Engaging in only those services or audit activities for which Internal Audit staff have the necessary knowledge, skills, and experience.
- Continually improving staff proficiency, and the effectiveness and quality of services.

MANAGEMENT RESPONSIBILITIES

It is the responsibility of the Board of Directors and senior management to foster a control environment that supports the Internal Audit Department's objectives and independence within the

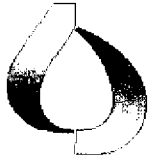
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Inland Empire Utilities Agency. The existence of the Internal Audit Department does not diminish Agency management's financial and operational responsibilities for prudent execution and control of activities, including their responsibilities for the periodic evaluation of risk, control, and governance systems.

Management's responsibilities include:

- Providing Internal Audit with its full support and cooperation at all operating levels, including full and complete access to all records, property, and staff relative to their assigned areas of responsibility, and active participation in the audit process.
- Immediately notifying the Manager of Internal Audit and the Audit Committee of any known or suspected cases of illegal, criminal or unethical activity involving Agency funds, property, employees, or any activity which appears to present a conflict of interest.
- Timely notification to Internal Audit of any new or proposed modifications to Agency systems, procedures, operations or services, ensuring controls are built into the new or modified processes.
- Providing the Internal Audit Department with written responses to all audit findings and recommendations, including action plans, responsible employees, and targeted resolution dates or the acceptance of the risks identified.
- Providing the Internal Audit Department with adequate budget, staffing, assistance from staff of audited Departments, and the tools needed for the Internal Audit Department to execute its duties as defined in this Charter.

Background/History



Inland Empire
UTILITIES AGENCY

Date: April 21, 2004

To: Honorable Board of Directors

Through: Finance, Legal & Administration Committee (4/19/04)

From: Richard W. Atwater *RWA*
Chief Executive Officer/General Manager

Larry S. Rudder
Chief Financial Officer

Patrick King
Human Services Administrator *PK*

Subject: Finance and Administration Accountability Recommendations

RECOMMENDATION

It is recommended that the Board of Directors:

1. Establish an Audit Committee of the Board of Directors;
2. Establish a new position of Internal Auditor, in the Unrepresented Group, Range UN102 (\$80,783 to \$98,426 annually), effective July 4, 2004;
3. Establish a new position of Assistant Auditor, in the Unrepresented Group, Range UN098 (\$66,459 to \$80,974 annually), effective July 4, 2004;
4. Establish a new position of Executive Manager of Finance and Administration in the Executive Management Group, Range EX103 (\$109,082 to \$132,906 annually), effective July 4, 2004; and,
5. Authorize the purchase of one personal computer for the new Assistant Auditor position at a cost not to exceed \$1,800.

BACKGROUND

At the February 4, 2004, Board of Director's meeting, the Board requested that staff analyze the issues and potential audit compliance concerns with the Agency's current organizational structure. This matter was reviewed at the March 10, 2004, Finance, Legal & Administration Committee meeting. After discussion, the Committee requested that staff conduct some additional research, and provide the Committee with additional information from the Agency's General Counsel and the Institute of Internal Auditors.

Key issues:

1. Lack of Board oversight of external Auditor activities;
2. Historically, the Agency's Internal Auditor has not prepared audit reports;
3. Reporting relationships – both the external Auditor and the Internal Auditor are supervised directly by the Chief Financial Officer position (inconsistent with recommendations of the Government Finance Officers Association (GFOA), and Institute of Internal Auditors, plus the California Legislature has recently proposed bills to modify the audit reporting). Exhibit 1 and 2.
4. Board and staff responsibilities related to governance of fiscal and administrative affairs.
5. Addressing the increased financial and administrative responsibilities of the Agency related to grant compliance and new financial responsibilities (e.g. Watermaster recharge project, CDA, IERCF).

Alternatives that the Board could implement:

1. Establish an Internal Auditor who would report directly to the Board of Directors;
2. Have a Chief Financial Officer who reports to the Board, and an Internal Auditor who also reports to the Board. Current organization, except for the addition of the Internal Auditor.
3. Have the Chief Financial Officer report directly to the Board and be responsible for the day-to-day administration of Finance and Accounting functions. Contracts, Procurement and Facilities Management, Human Resources and Information Services would report to the General Manager. The Internal Auditor would report directly to the Audit Committee. Refer to Alternative 3 Organization Chart.
4. Have the Chief Financial Officer report directly to the Board and be responsible for the day-to-day administration of the Finance and Accounting functions. Establish an Executive Manager of Administration who would report to the Chief Executive Officer/General Manager. The Executive Manager of Administration would be responsible for the day-to-day administration of the Human Resources, Information

Services, and Contracts, Procurement and Facilities Management Departments. The Internal Auditor would report directly to the Board of Directors Audit Committee. Refer to Alternative 4 Organization Chart.

5. Have the Finance and Accounting, Human Resources, Information Services, and Contracts, Procurement and Facilities Management Departments report to the Chief Executive Officer/General Manager, through an Executive Manager of Finance and Administration. The Assistant Auditor would report to the Internal Auditor, who would report directly to the Audit Committee. Refer to Alternative 5 Organization Chart. Alternative 5 is the alternative that is being recommended by staff.
6. Have a Chief Financial Officer responsible for the day-to-day administration of the Finance and Accounting functions, who would report directly to the Chief Executive Officer/General Manager. Have an Executive Manager of Administration responsible for the Human Resources, Information Services, and Contracts, Procurement and Facilities Management Departments, who report directly to the Chief Executive Officer/General Manager. The Assistant Auditor would report to the Internal Auditor, who would report directly to the Audit Committee. Refer to Alternative 6 Organization Chart.
7. Have a Chief Financial Officer responsible for the day-to-day administration of the Finance and Accounting functions, who would report directly to the Chief Executive Officer/General Manager. Have an Executive Manager of Administration responsible for the Human Resources, Information Services, and Contracts, Procurement and Facilities Management Departments, who would report directly to the Chief Executive Officer/General Manager. Upgrade one of the existing manager positions (i.e.; Human Services Administrator, Manager of Information Services, or Manager of Contracts, Procurement and Facilities Management), and upgrade one position in the department where the Manager position was upgraded to a level high enough to handle the routine daily operations of the respective department. The Executive Manager would then be required to exercise greater day-to-day oversight of the respective department. The Assistant Auditor would report to the Internal Auditor, who would report directly to the Audit Committee. Refer to Alternative 7 Organization Chart. The organization chart depicts this alternative with the Human Services Administrator being upgraded for visual purposes only.

Over the years, the Agency has utilized a number of approaches to address the Agency's financial and administrative responsibilities. At various times, the Agency has administered its financial affairs by utilizing a Controller, Financial Services Officer or Chief Financial Officer. Some of those positions reported directly to the Board of Directors, with secondary reporting responsibility to the Assistant General Manager or General Manager. Others reported directly to the Assistant General Manager or General Manager, with secondary reporting responsibility to the Board of Directors. In the past, the Agency's administrative responsibilities were administered partially by the Controller, the Board Secretary, the Manager of Administrative Services, and the Executive Manager of Administration and Resources.

As was discussed at the February 4, 2004, Board meeting, due to the upcoming retirement of the Chief Financial Officer, staff undertook the task of reviewing the finance and administrative activities of the Agency. Staff utilized Lillestrand and Associates to assist in the management analysis of the finance and accounting organization recommendations to improve productivity and effectiveness. Currently the Managers of Accounting, Contracts, Procurement & Facilities Management, Human Resources, and Information Services report directly to the Chief Financial Officer. As previously discussed with the Board, as a means of ensuring adequate financial controls and providing timely/accurate financial information to the Board, staff has reviewed the Agency's financial and administrative reporting relationships. While the current structure has been acceptable, with the growth of the Agency, both the financial and administrative responsibilities have increased substantially, as demonstrated by the following information.

	<u>FY 1993/94</u>	<u>FY 2003/04</u>
O/M Budget	\$64,000,000	\$ 82,600,000
Capital Budget	\$16,400,000	\$142,400,000
Revenue	\$80,400,000	\$178,000,000
Investment Portfolio	\$30,000,000	\$ 95,000,000
Staffing Levels	276*	260

* Between FY 1993/94 and FY 1999/2000 staffing was reduced to 219 positions

Additionally, over the same ten-year period, the Agency has issued \$225,000,000 in bonds, has received or applied for \$163,362,836 in federal/state grants, has assumed responsibility for a number of local projects/rebate programs with the Metropolitan Water District, and is now responsible for the administration and financial functions for the Chino Basin Desalter Authority, the Inland Regional Composting Authority and the financial functions related to the cooperative Agreement between the Agency, the CBWM, CBWCD and SBCFCD for the Groundwater Recharge Project. Further, the Agency is very active in projects with Watermaster and SAWPA.

In addition, the legislature has held hearings on special districts "integrity and accountability" (November 2003) that included the following recommendations regarding annual audits:

- Require that only a district board can hire external auditors.
- Require auditors to test expenses at a higher level than regular testing for financial statements.
- Encourage boards to ask auditors to conduct compliance reviews for contractual obligations and district's policies.
- Require auditors to provide a written management letter to the board.
- Require the rotation of audit partners every five years, following the federal Sarbanes-Oxley Act.

It is expected that the California Legislature will enact special district legislation this year that will enact specific auditing requirements and reporting of expenditures for special districts.

To address this increase in responsibility, to ensure administrative and financial accountability to the standards required by federal and state regulatory agencies and bondholders, to better define staff's administrative responsibilities, and to provide the Board with a consistent means of monitoring the Agency's financial responsibilities, staff is proposing a realignment of responsibilities as follows:

1. An Audit Committee of the Board of Directors be established to oversee the audit and grants responsibilities of the current Chief Financial Officer position. The Committee would be responsible to meet at least quarterly with the Agency's Internal Auditor and Agency staff, for overseeing the acquisition of the Agency's outside Auditor, developing the scope of work for the annual audit, approving the annual audit work plan, directing special internal audits, reviewing and approving the internal auditing work plans, evaluating the performance of the internal audit activities, and providing policy direction to the Agency's Audit and Grants Department. The Audit Committee would meet at least quarterly with the Internal Auditor to review work plans, audit activities and the draft/final audit reports. The Audit Committee would submit all audit management reports to the Board for review and policy direction, as appropriate.
2. An Audit and Grants Department be established and assigned responsibility for supervising the Agency's annual outside audit, review of the draft and final annual audit report with the Board, supervision of all internal audits, review of all expenditures over \$100,000, coordination of all grant administration and reporting, and the development of special reports to the Board of Directors regarding the effectiveness of Agency projects/operations.
3. An Internal Auditor position be established to direct the Audit and Grants Department, and who would report directly to the Audit Committee, with a working relationship with the Chief Executive Officer/General Manager. This reporting relationship would be the same as the current relationship that General Counsel and the External Auditor have with the Board and the Chief Executive Officer/General Manager. This is consistent with the Water Code provisions for municipal water districts and the proposed legislation for special districts (Coteze bill).
4. An Executive Manager of Finance and Administration be established to assume the administrative responsibilities of the current Chief Financial Officer. The Executive Manager of Finance and Administration would report directly to the Chief Executive Officer/General Manager. This position would be responsible for the Agency's Accounting and Finance, Contracts, Procurement and Facilities Management, Human Resources, and Information Services functions. This individual should have a sound background/understanding of each of the four areas of responsibility in order to provide effective oversight of the division and to provide meaningful financial and administrative consultation to the Chief

Executive Officer/General Manager and the Board of Directors. This reporting structure is consistent with most city and municipal water district organizations.

5. An Assistant Auditor position be established in the Audit and Grants Department to supplement the workforce to ensure that the Department Manager has the staff to accomplish the additional responsibilities. Depending on how the first year of the new Audit and Grants Department does in addressing these new responsibilities, it might be necessary to add additional auditing staff in future years.

This realignment is the same approach used in FY 2000/01 when the responsibilities of the Executive Manager of Engineering and Operations were realigned, due to growth, between an Executive Manager of Engineering/Planning and an Executive Manager of Operations. It is anticipated, that if approved by the Board, the proposed realignment of responsibilities would:

- Ensure that the Agency maintains the highest standard of fiscal integrity and accountability;
- Provide a truly independent review of Agency financial functions by separating the audit and the administrative duties;
- Provide a sound checks and balances system for not only daily financial activities, but specifically for all purchases over \$100,000;
- Address the Board's concerns regarding internal auditing and the reliability of information being provided to the Board;
- Provide the Board substantially more direct input into the Agency's annual audit, through the Audit Committee;
- Provide for more direct supervision over the Agency's administrative areas of responsibility by realigning responsibilities to a more manageable level;
- Provide additional administrative support to the Board and the Executive Management team;
- Provide additional direction to addressing the long-term financial and operational goals of the Agency; and,
- Bring the Agency's fiscal and administrative organization more in line with how special districts in California are managed.

As discussed with the Board and the Finance, Legal, & Administrative Committee, staff has reviewed the Agency's administrative, financial and auditing functions, with the Agency's bond counsel, Doug Brown (Stradling Yocca Carlson and Rauth), investment banker, Dave Houston (Citigroup), current external auditor, Ken Al-Imam (Conrad and Associates), General Counsel, Jean Cihigoyenette and the Metropolitan Water District's Chief Financial Officer, Brian G. Thomas through three conference call meetings. It was the consensus of the above individuals that the proposed reorganization was in the best interests of the Agency. It was discussed during the review that:

- The current relationship of the outside Auditor reporting to the Chief Financial Officer does not provide clear independence for the audit function and is not recommended by the GFOA.
- The Internal Auditor has not performed formal internal audit reports. It is recommended that the Internal Auditor be the contract administrator for the Agency's outside auditor, Conrad and Associates, and report directly to the Board through an Audit Committee of the Board. The Audit Committee would meet periodically throughout the year to review the work of the Auditor. The Internal Auditor would continue its grants administration function since that is a significant audit compliance activity (the Agency will be subject to future audits by MWD, federal and state agencies regarding the proper expenditure of grant funds consistent with the grant agreements).
- Traditionally staff responsible for the daily administration of support departments (Accounting, Contracts, Procurement and Facilities Management, Human Resources, and Information Services) report to an Executive Manager of the organization and not to the Chief Financial Officer.
- The use of an Audit Committee of the Board should provide the Board with additional input into both the internal and external audit processes.
- The use of an Audit Committee should actually strengthen the process, as it will provide for a clearer division of responsibilities and reporting assignments. Private sector firms are starting to use more audit committees as a means of improving financial oversight.
- To effectively implement the internal audit function, the review group recommended that an additional staff person (Assistant Auditor) be retained to perform this function.

While the Agency's current Chief Financial Officer has participated in some of the discussions regarding this proposal and concurs with some of the recommendations (i.e.; creation of an Audit Committee, employing an Assistant Auditor, increased financial oversight) he does not recommend that the Chief Financial Officer report directly to the Chief Executive Officer/General Manager. It is his opinion that having the Chief Financial Officer who reports directly to the Board of Directors provides for a needed set of checks and balances.

As requested by the Finance, Legal & Administration Committee at their March 10, 2004 meeting, staff has reviewed the matter of the Audit Committee's makeup with General Counsel. General Counsel stated that as with other Agency committees, members of the Audit Committee, regardless if they are current Board members or appointed by the Board from outside of the Agency, are subject to the requirements of the Brown Act. General Counsel did suggest that the Board consider the following issues prior to appointing an individual from outside of the Agency:

1. Would the individual appointed be from a member agency or from the general public?
2. What means would be used to select the individual (i.e.; a public advertisement requesting volunteers, recommendations from Board members, recommendations from our member agencies, etc.)?
3. What would be the responsibilities of the appointee?
4. What would be the requirements to be considered to serve on the Audit Committee?
5. How long would the individual's term be?
6. Would the individual be a volunteer or would they receive compensation for serving on the Audit Committee?

General Counsel did suggest that the Board could inquire if the current Chief Financial Officer would like to be appointed to the Audit Committee.

It was General Counsel's opinion that the Board could establish an Audit Committee made up of just current Board members or a combination of current Board members and a representative(s) from the public.

As requested by the Finance, Legal, & Administration Committee, staff has been in contact with the Institute of Internal Auditors regarding the benefits and/or drawbacks to the proposal of having the person responsible for the Agency's financial affairs reporting directly to the Chief Executive Officer/General Manager.

Institute of Internal Auditors Findings by Brian Kruk on 3/24/04:

- CFO should report to CEO.
- If CFO does not report to CEO, it can make the CEO's job more difficult.
- The CEO should have administrative control over budget preparation.
- IEUA's proposed changes are in the right direction.
- The Internal Auditor should answer to an Audit Committee.
- The only problem might be if the CEO or CFO has significant administrative control over the Internal Auditor (i.e. write performance appraisals, award raises), then the Internal Auditor might be reluctant to go over CEO or CFO's head. (This should not be an issue at IEUA since the Board does the appraisals and awards raises).

As was discussed at the March 10, 2004, Finance, Legal, & Administration Committee, staff has been reviewing the placement of the Environmental Compliance Department within the organization. At the present time, the responsibilities of the Environmental Compliance Department are supervised by the Executive Manager of Operations. From an organizational standpoint, it is not sound management practice to have the compliance enforcement department under the supervision of the Division that they are monitoring for compliance. Staff has completed their preliminary review of other similar sanitation districts and water agencies (OCSO, LACS, MWD, Los Virgenes MWD and Eastern MWD) and all have Environmental Compliance not reporting to the Manager of Operations, but a separate technical services group. Staff is evaluating options and will be recommending that the supervision of the Environmental Compliance Department report to another Executive Manager. Since one of the key components of our Environmental Compliance Department should be representing the Agency at regulatory hearings, this proposed placement should merge both the technical and policy issues for the Agency to proactively comply with the regulatory and legislative process within one Division.

As previously discussed, this review and the ultimate recommendations were only undertaken due to the retirement of the current Chief Financial Officer. The recommendations are not a reflection on him or his staff's abilities or performance, but are being made to strengthen our existing system.

PRIOR BOARD ACTION

This matter was presented to the Board as an informational item at the February 4, 2004, meeting and was discussed by the Finance, Legal & Administration Committee at their March 10, 2004, meeting.

IMPACT ON BUDGET

The impact on the Agency's 2004/05 Fiscal Year Budget would be an increase of approximately the following amounts for each of the Alternatives:

Alternative No. 3	\$105,350
Alternative No. 4	\$228,237
Alternative No. 5	\$ 84,657 (alternative being recommended)
Alternative No. 6	\$214,549
Alternative No. 7	\$104,701

As requested by the Finance, Legal, & Administration Committee, the Chief Financial Officer has reviewed the calculation used to prepare the above cost estimates. After the review, he is satisfied that the estimates accurately reflect the personnel costs that would be encountered by the Agency for each of the alternatives being proposed.

RWA:PK:jbs

G:\board-rec\2004\04133 Finance & Accountability Recommendations

GFOA Recommended Practice

Establishment of an Internal Audit Function (1997)

Recommendation. The Government Finance Officers Association (GFOA) makes the following recommendations regarding the internal audit function.:

1. Every government should consider the feasibility of establishing a formal internal audit function because such a function can play an important role in helping management to maintain a comprehensive framework of internal controls. As a rule, a formal internal audit function is particularly valuable for those activities involving a high degree of risk (e.g., complex accounting systems, contacts with outside parties, a rapidly changing environment).
2. The internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means.
3. It is recommended that internal auditors of state and local governments conduct their work in accordance with professional standards relevant to internal auditing contained in the U.S. General Accounting Office's publication *Government Auditing Standards* (i.e., generally accepted government auditing standards). These standards direct, for example,, that internal auditors "report the results of their audits and be accountable to the head or deputy head of the government entity and should be organizationally located outside the staff or line management function of the unit under audit." (Section 3.19)
4. At a minimum, the head of the internal audit function should possess a college degree and appropriate relevant experience. It also is highly desirable that the head of the internal audit function hold some appropriate form of professional certification (e.g., certified internal auditor, certified public accountant, certified information systems auditor).
5. All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government's audit committee or its equivalent.

References

- *Governmental Accounting, Auditing and Financial Reporting (GAAFR)*, Stephen J. Gauthier, GFOA, 1994.
- *Evaluating Internal Controls: A Local Government Manager's Guide*, Stephen J. Gauthier, GFOA, 1997. GFOA Recommended Practice

Establishment of Audit Committees (1997)

Recommendation. The Government Finance Officers Association (GFOA) makes the following recommendations regarding the establishment of audit committees by state and local governments:

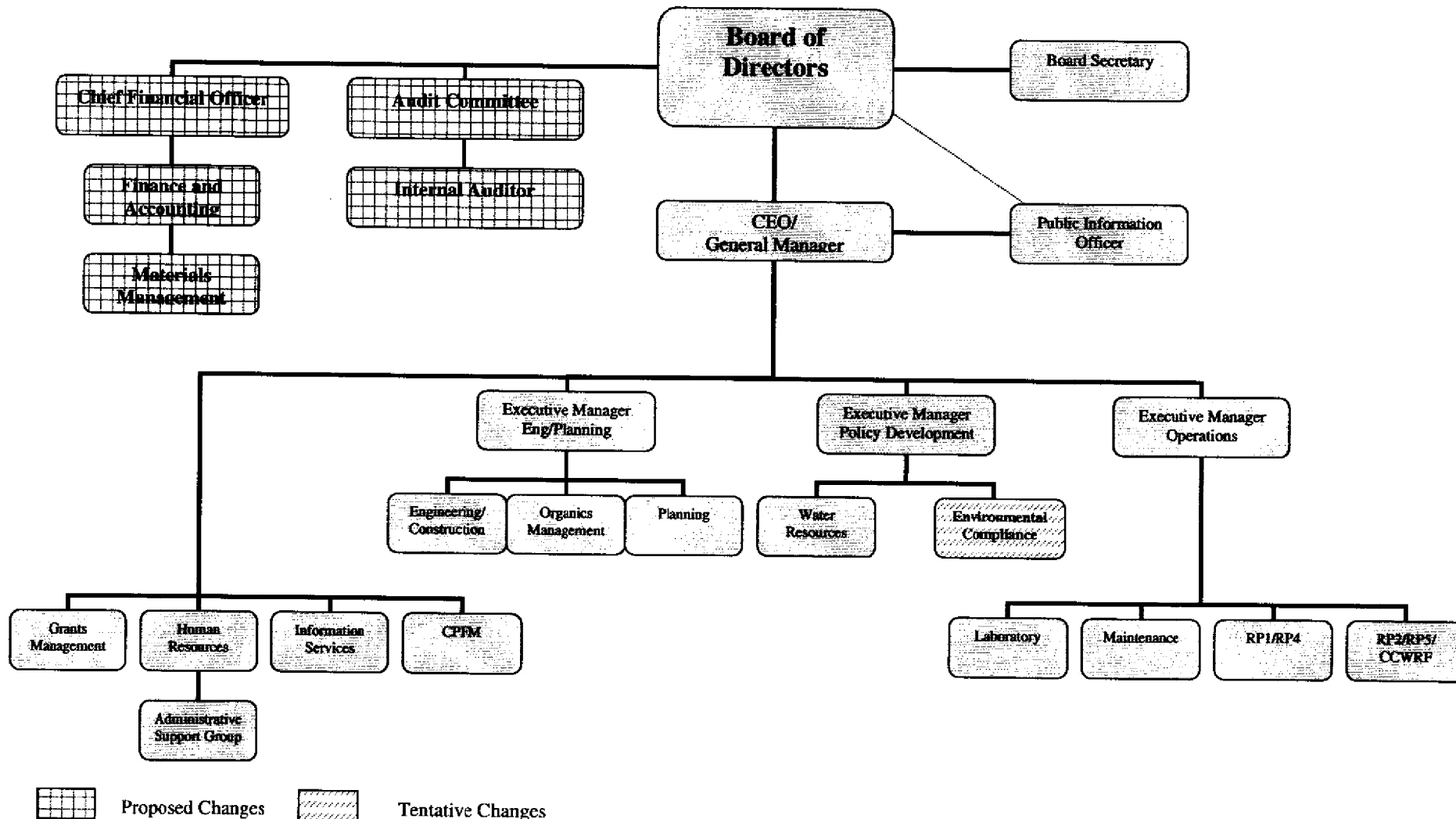
1. Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by state and local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor, and hence the reliability of the financial statement audit.
2. The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means.
3. The members of the audit committee collectively should possess the expertise and experience in accounting, auditing, and financial reporting needed to understand and resolve issues raised by the independent audit of the financial statements.
4. A majority of the members of the audit committee should be selected from outside of management. At the same time, the audit committee should include at least one representative each from the executive and legislative branches of the government.
5. An audit committee should be sufficiently large to ensure that its members possess all of the skills needed to realize the committee's objectives. At the same time, the audit committee should be small enough to operate efficiently. Therefore, as a general rule, an audit committee should be composed of no less than five and no more than seven members.
6. The primary responsibility of the audit committee should be to oversee the independent audit of the government's financial statements, from the selection of the independent auditor to the resolution of audit findings.
7. The audit committee should have access to the reports of any internal auditors, as well as access to any annual internal audit work plans.
8. The audit committee should present annually to the government board and management a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public.

References

- *The Audit Management Handbook*, Stephen J. Gauthier, GFOA, 1989.
- Audit RFP Diskette, GFOA.

CFO Reports to the Board/Admin. Depts. Report Directly to CEO/GM

04/14/2004

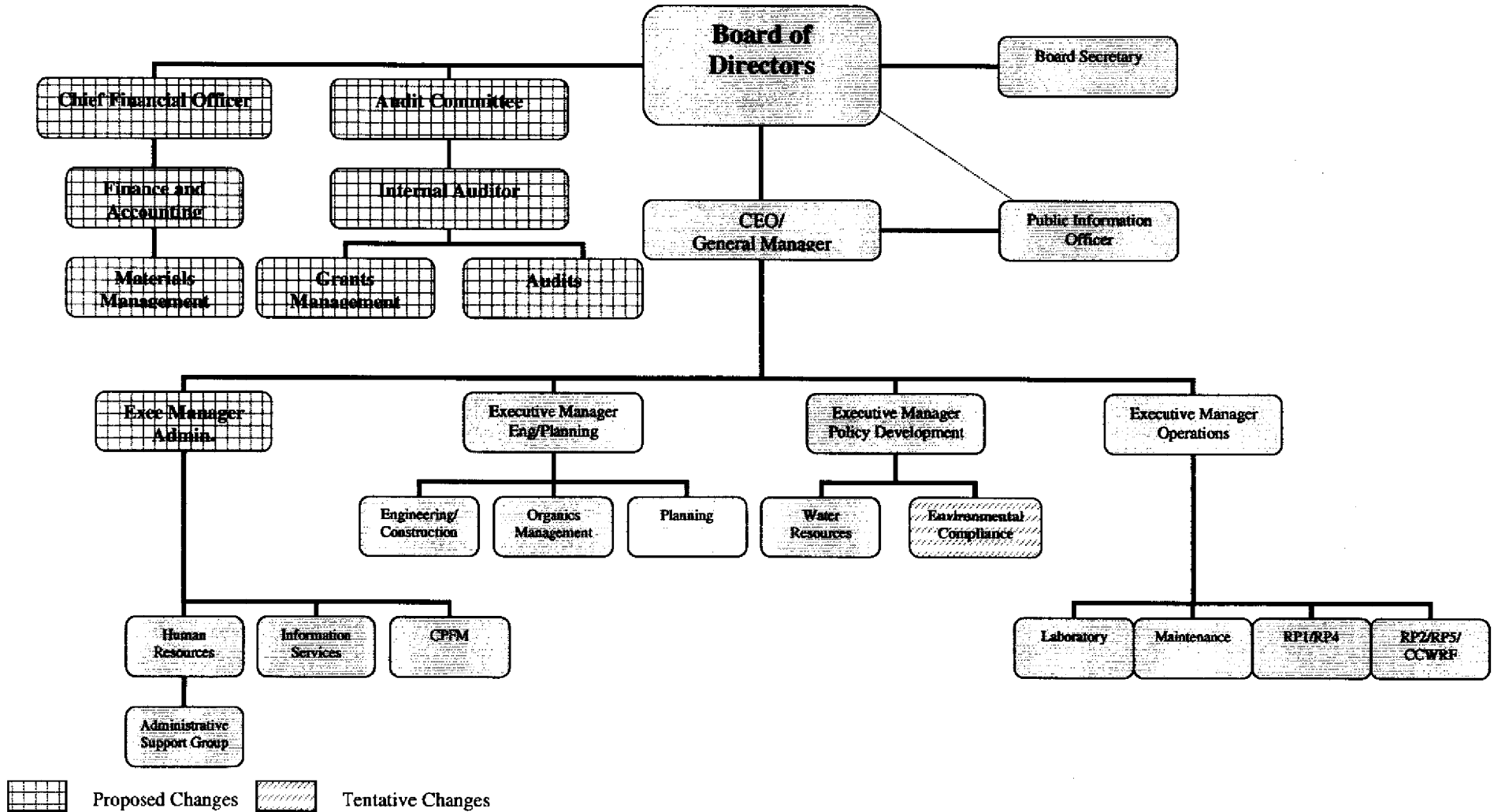


Alternative 3

Estimated Cost \$105,350

CFO Reports to the Board/Ex. Manager Admin. Report to the CEO/GM

04/14/2004

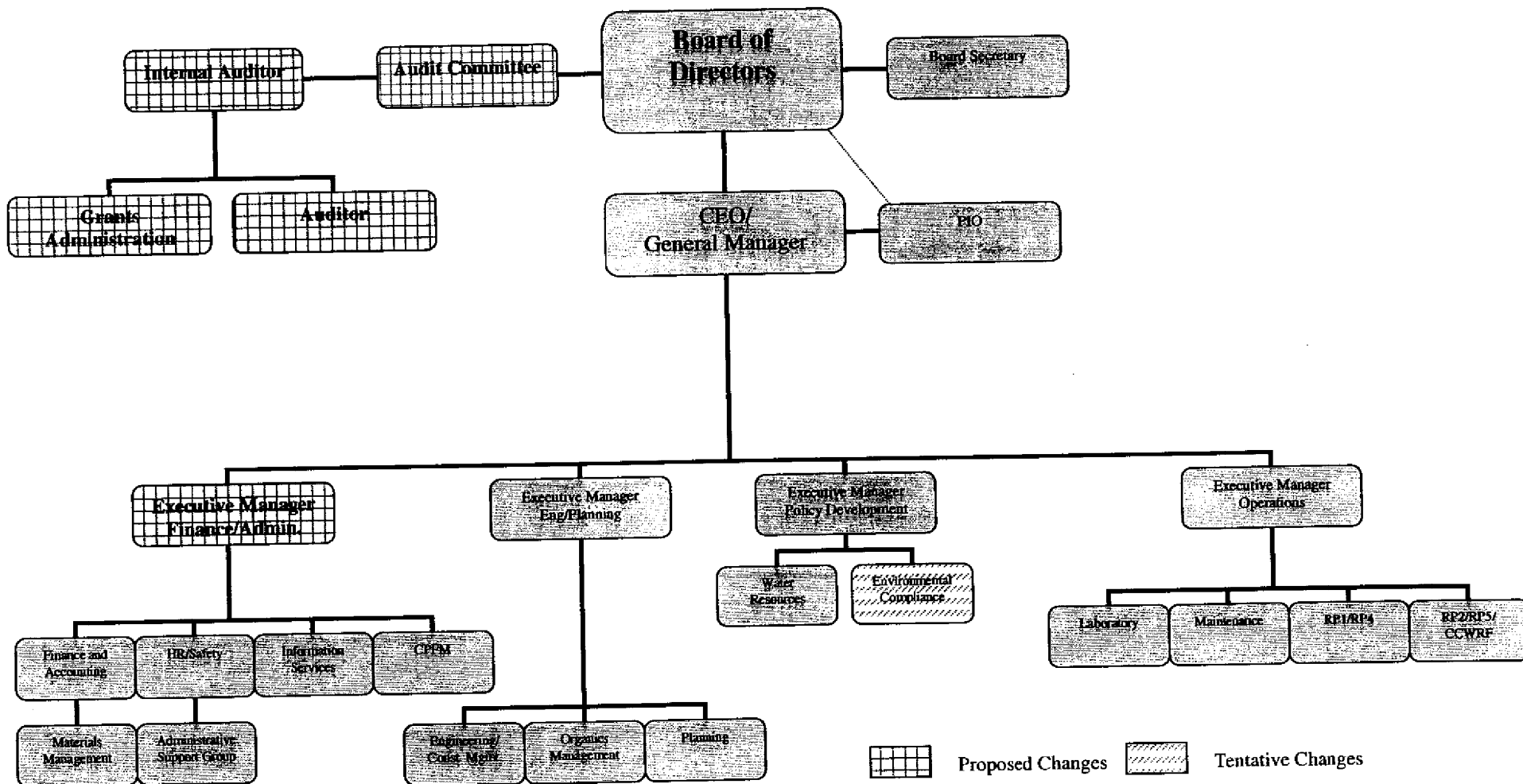


Alternative 4

Estimated Cost \$228,237

Exec. Manager of Finance/Admin. Report to CEO/GM

04/14/2004

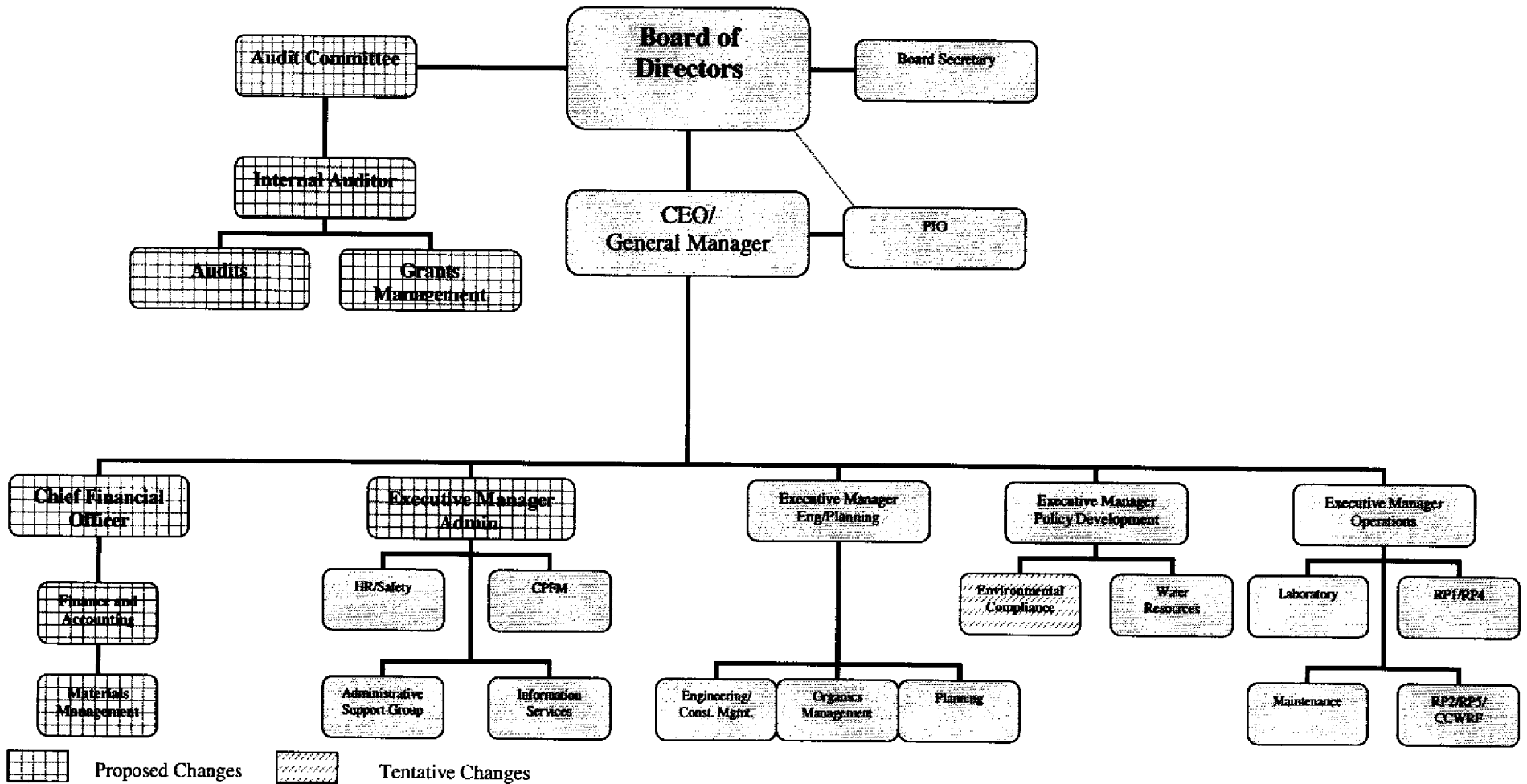


Alternative 5

Estimated Cost \$84,657

Audit Committee Report to BOD, CFO and Exec. Manager Admin. Report to CEO/GM

04/14/2004

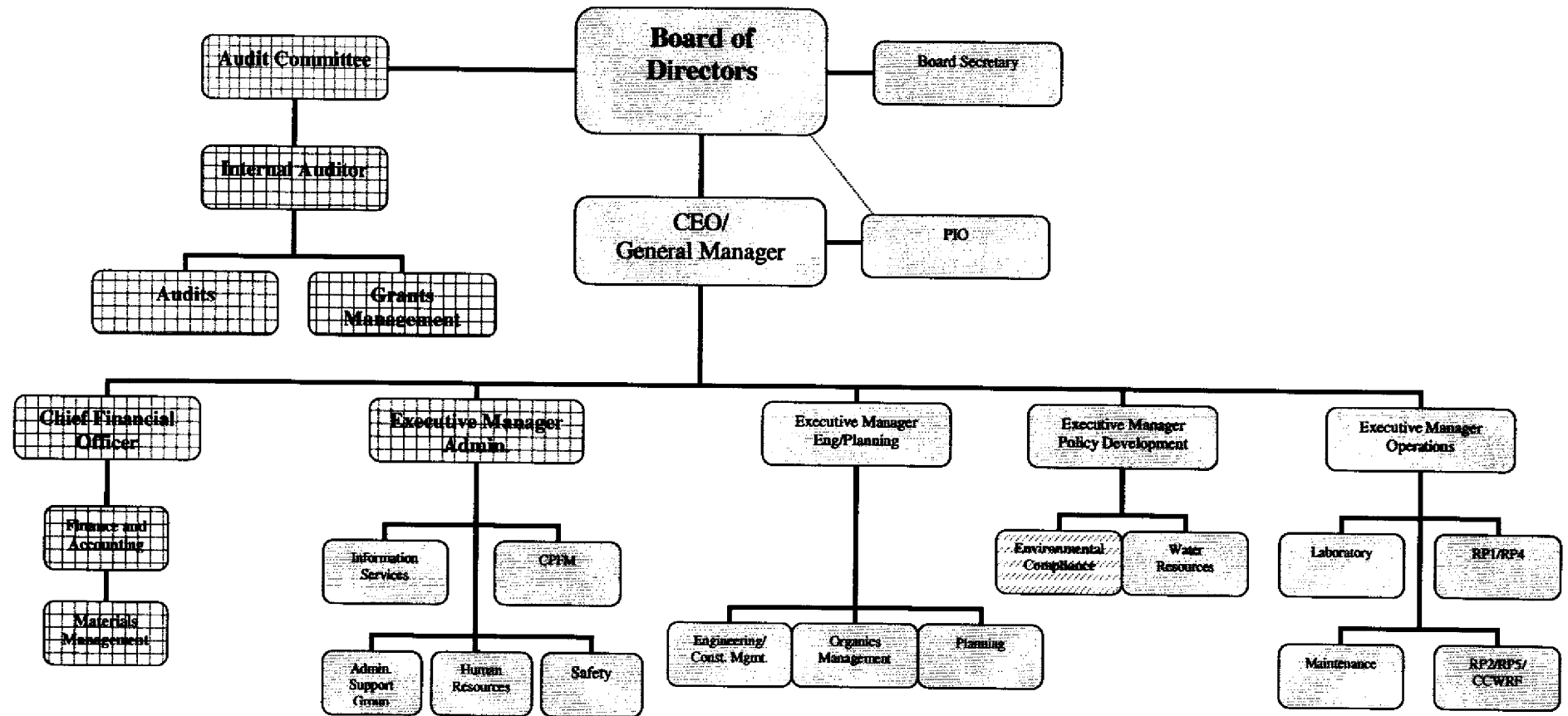


Alternative 6

Estimated Cost \$214,549

Audit Committee Report to the Board, and CFO and Ex. Manager Admin. Report to CEO/GM
 (One department manager position eliminated)

04/14/2004



 Proposed Changes

 Tentative Changes

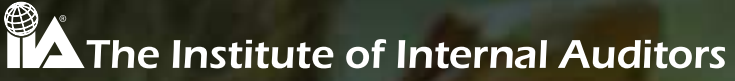
Alternative 7

Estimated Cost \$104,701

Institute of Internal Auditors

(Guidance and Standards)

Clarifying what it takes to be responsible, knowledgeable, and effective



THE AUDIT COMMITTEE: PURPOSE • PROCESS • PROFESSIONALISM



A NEW WORLD OF CORPORATE GOVERNANCE

Today's governance arena requires boards of directors and their committees to be proactive, informed, investigative, and accountable. This, indeed, is good news for stakeholders. After all, isn't it about time that somebody asks the tough questions, looks beneath the surface, and models accountability?

If there is a bad-news side to this new-world story, it's that the stakes are greater than ever. Gone is the day of the "figure-head" board member whose resumé proudly lists — in double digits — the prestigious boards on which he or she sits. And "sitting" hardly describes what takes place in today's boardroom . . .

The public, still reeling from corporate shenanigans brought to light over the past few years, is more demanding and less trusting than ever, and rightfully so. Directors face greater challenges and more liabilities and must err on the side of caution in regard to risk management, ethics, policies, procedures, and organizational leadership. To say the least, their plate is full.

CLARIFYING GOVERNANCE

Governance is the system by which organizations are directed and controlled. It includes the rules and procedures for making decisions on corporate affairs to ensure success while maintaining the right balance with the stakeholders' interest.

Responsibility for corporate governance is spread among several organizational entities. The cornerstones of effective governance are the board of directors, executive management, the internal auditors, and the external auditors. No single committee of the board is more focused on or better in tune with governance than the audit committee.

What is the audit committee's role in governance? In a nutshell, the audit committee should provide oversight of financial reporting, risk management, internal control, compliance, ethics, management, internal auditors, and the external auditors.

CLARIFYING LIABILITY

Directors need to be realistic about their own personal liability under state and federal law, neither exaggerating nor ignoring their exposure.

Fiduciary duties — the duties of care and loyalty, and the expectation that directors will act in good faith — are still the primary source of director liability under state law. Although directors are not subject to significantly greater risk of being found liable for a breach of fiduciary duty, rising stockholder-plaintiff activism has increased the risk that directors may need to defend themselves in litigation alleging such a breach.

Board members who wish to become empowered guardians and builders of corporate value must learn and follow best practices, such as avoiding conflicts of interest and paying strict attention to board matters, drawing on appropriate expertise, including their own.

Source: DIRECTOR LIABILITY: MYTHS, REALITIES, AND PREVENTION
National Association of Corporate Directors



THE AUDIT COMMITTEE: PURPOSE • PROCESS • PROFESSIONALISM



Some detailed audit committee responsibilities include:

- Ensuring that financial statements are understandable, transparent, and reliable.
- Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.
- Helping achieve an organization-wide commitment to strong and effective internal controls, emanating from the tone at the top.
- Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, and the investigation of misconduct and fraud.
- Reviewing current and pending corporate-governance-related litigation or regulatory proceedings to which the organization is a party.
- Continually communicating with senior management regarding status, progress, and new developments, as well as problematic areas.
- Ensuring the internal auditors' access to the audit committee, encouraging communication beyond scheduled committee meetings.
- Reviewing internal audit plans, reports, and significant findings.
- Establishing a direct reporting relationship with the external auditors.

THE TONE AT THE TOP

Management, the board, and the audit committee all play critical roles in an organization's tone at the top. Based on board expectations, executive management establishes the tone. It is the audit committee's responsibility, though, to monitor that tone as well as oversee the organization's ethical environment and compliance with laws and regulations.

Leading audit committee practices in code-of-conduct oversight include:

- Ensuring that a code of conduct has been developed.
- Reviewing it, approving it, and each year, discussing whether revisions are needed.
- Ensuring that all employees receive the code of conduct, understand it, and obtain appropriate training regarding it.
- Ensuring that the board receives a copy of the code and related training.
- Ensuring that communications channels are working effectively.
- Receiving and reviewing a summary of reported violations and follow-up actions.
- Ensuring that management exhibits ethical behavior in its role of establishing the tone at the top.

Leading audit committee practices in overseeing compliance and ethics programs include:

- Ensuring compliance with laws and regulations.
- Staying informed about how management is monitoring program effectiveness and making changes as necessary.
- Meeting periodically with the program manager to discuss key risks, status, issues, and effectiveness.
- Staying informed on significant issues, investigations, and disciplinary actions.
- Recognizing trends and reviewing management's plans to address them.
- Ensuring management discloses in the financial reports the impact of significant issues.
- Ensuring the internal auditors include assessment of compliance and ethics risks in their audit plan.



COMPLIMENTARY SUBSCRIPTION

Stay in the know about issues critical to audit committees, boards, and executive management. The Institute of Internal Auditors' corporate governance newsletter — *Tone at the Top* — is available both electronically and in hard copy, free of charge. Contact pr@theiia.org to ensure you receive this timely resource in the format of your choice. Please designate "Code ACB" when you make your request.



NOSES IN. FINGERS OUT.

Balancing their role as advisor and counselor to management with their fiduciary duty to monitor and oversee management is, to say the least, challenging for most audit committees. They must communicate openly and often with management, carefully review information received, and challenge management as appropriate. They must not, though, play the management role. Some refer to this oversight responsibility as “Noses in; fingers out.”

The lines of authority for audit committees and management should in no way be murky. There should be a clear understanding and consensus regarding where management ends and the audit commit-

tee begins. To ensure this clarity, strong communications are essential both during and outside of committee meetings. Management should view the audit committee as an asset and seek its input prior to, rather than after making key decisions.

Ongoing communication will help build a trusting relationship between the audit committee and management. However, it requires time and commitment of both parties. To clarify the level of communication that you as an audit committee member should expect, review the “Communications Checklist” below.

COMMUNICATIONS CHECKLIST

- Management is easily accessible.
- Management reaches out to you regularly.
- Management answers your questions fully and promptly.
- Management provides factual information to support responses.
- Management admits not knowing an answer.
- Management supports the audit committee by contacting additional resources and specialists.
- Management advises you of significant issues in a timely manner.
- Management seeks your input in advance of key decisions.

The audit committee also should ensure the financial leadership team is well-qualified and competent, succession planning issues are addressed, and the entire financial activity is strong.



KEY ISSUES OF CONCERN

What keeps audit committee members awake at night? Among at least a dozen things they have (or should have) on their minds are five key issues: financial accuracy, risk management, control assessment, external auditor oversight, and the effective use of internal auditing.

Financial Accuracy

The primary concerns about financial accuracy include the completeness of financial disclosures, significant business and accounting policy changes, correct and truthful reporting, and interim reviews of financial statements. Audit committee members should know the right questions to ask to build their financial acumen. They should be aware of the thresholds of materiality, compare current accounting policies with other alternatives, review key estimates versus historical data, and discuss the areas most susceptible to fraud. They also should ask for the internal and external auditors' opinions, read and compare the narratives with other information, and use a checklist for meeting disclosure requirements.

Risk Management

An enterprise-wide risk management process, such as COSO's *Enterprise Risk Management – Integrated Framework* should be implemented, in which key risks to all areas of the organization (strategic, operational, reporting, and compliance) are identified. Enterprise risk management (ERM) is a structured and coordinated entity-wide governance approach to identify, quantify, respond to, and monitor the consequences of potential events. The organization should learn from the past by monitoring the risk realization history, as well as plan for the future by identifying emerging risks. NOTE: All risk is not bad. There must be discussions on the organization's "appetite" for risk, consensus on what is considered the acceptable level of risk, and a process for risk monitoring.

Control Assessment

For effective control assessment processes, the audit committee should have upfront involvement. It must have an understanding of management's process for assessing internal controls, applicable regulatory controls, and the greatest risks the organization faces. There should be in place a process for assessing and reporting on not only financial controls, but also controls throughout the enterprise. Also, a fraud prevention and detection program should be established. There should be clarification and agreement on terminology, definitions, and issues to be discussed. Inherent in the entire process should be transparency of disclosures, updates, discussions on control impacts, oversight monitoring, a review of the external auditors' assessment plan and discussion of their opinions, and

CLARIFYING COSO

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. COSO comprises the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA).

Web site: www.coso.org



review of the techniques in place for fraud identification.

NOTE: COSO's *Internal Control – Integrated Framework* is a helpful tool.

External Auditor Oversight

The audit committee should own the relationship with the external auditors, who provide an annual opinion on the financial statements. Ownership requires direct reporting, ongoing communication, frequent meetings, and robust discussions about audit scope and results. Oversight issues also include compensation, scope, selection criteria, independence, rotation, monitoring, and performance assessment. If management, rather than the audit committee, owns the relationship with the external auditors, the committee should take immediate steps to claim ownership.

Effective Use of Internal Auditing

Performed by professionals with an in-depth understanding of the business culture, systems, and processes, the internal audit activity provides assurance that internal controls in place are sufficient to mitigate the risks, that the governance processes are adequate, and that organizational goals and objectives are met.

The audit committee and the internal auditors are interdependent and should be mutually accessible, with the internal auditors providing objective opinions, information, support, and education to the audit committee; and the audit committee providing validation and oversight to the internal auditors.

The Certified Internal Auditor (CIA) demonstrates professionalism and competency, and the *International Standards for the Professional Practice of Internal Auditing (Standards)* outline the tenets of the internal audit profession. The internal audit activity should be conducted in accordance with the *Standards*, should have in place a Quality Assurance

and Improvement Program, and should have and follow an internal audit charter. The work of the internal and external auditors should be coordinated for optimal effectiveness and efficiency.

CLARIFYING AUDITOR INDEPENDENCE

The external auditors are independent of the organization. By contrast, the internal auditors, who are integral to their organization, demonstrate organizational independence and objectivity in their work approach and are independent of the activity they audit. The internal auditors' reporting relationship to the audit committee is critical to independence of their activity.



CLARIFYING THE VALUE OF INTERNAL AUDITING

Having an in-depth understanding of internal audit objectivity, reporting structure, independence, staffing, prioritization, and how your internal audit activity adds value will help you stay on purpose.

Objectivity

To maintain objectivity, internal auditors should have no personal or professional involvement with or allegiance to the area being audited; and should maintain an un-biased and impartial mindset in regard to all engagements.

Reporting Structure

To ensure transparency and thwart collusion and conflicts of interests, best practice indicates that the internal audit activity should have a dual reporting relationship. The chief audit executive (CAE) should report to executive management for assistance in establishing direction, support, and administrative interface; and to the audit committee for strategic direction, reinforcement, and accountability.

Independence

The internal audit charter should establish independence of the internal audit activity by the dual reporting relationship. The internal auditors should have access to records and personnel as necessary, and be allowed to employ appropriate probing techniques without impediment.

Risk Management

Implemented by management, ERM is evaluated by the internal auditors for effectiveness and efficiency. Specifically, risk mitigation and residual risks should be reviewed, and the internal auditors should provide an opinion on the risk management process.

Staffing

A broad range of skills and expertise, and ongoing professional development are critical to the formation and maintenance of an effective internal audit activity. Essential elements include in-depth knowledge of the organization's industry, and internal audit *Standards* and best practices; technical understanding and expertise; knowledge on and skills for implementing and improving processes in both financial and operational areas; and strong communication and presentation skills.

Although some co-sourcing and outsourcing might be necessary when unique competencies and specialty skills are not affordable or available, the internal audit activity should be managed from within the organization.

Prioritization

Effective prioritization involves staying in sync with the organization's risk priorities and taking a risk-based approach to internal audit planning. By continuously monitoring organizational changes that might alter the plan, the CAE should be well equipped and positioned to make informed and educated recommendations to management and the board on the most effective use of internal audit resources.

Adding Value

Internal auditing serves management and the board, assesses the ethical climate and the effectiveness and efficiency of operations, and provides a safety net for organizational compliance with rules, regulations, and overall best business practices.



ASKING THE RIGHT QUESTIONS

Because the audit committee is responsible to the board for oversight of management reporting on internal control, and because the internal auditors play a key role in assessing and reporting on risk management and internal controls, these two entities share a healthy interdependence. The critical connection between audit committee effectiveness and internal auditing mandates that committee members maintain an in-depth understanding of internal audit best practices and how their internal audit activity is functioning.

At the very least, every audit committee member should be able to correctly answer the 20

questions below. These questions will serve as a tool to trigger awareness of the areas for which committee members might need more information. For definitions, explanations on why each topic is important, and best-practice recommendations, please refer to www.theiia.org. Enter key words, Audit Committee, in the search engine and review “20 Questions.” Based on the guidance included in the full document, you may determine the need for additional information on your specific organization. Many of the answers you seek will reside with the CAE. You may want to discuss others, however, with your organization’s executive management team.

1. Should we have an internal audit activity?
2. What should our internal audit activity do?
3. What should be the mandate of our internal audit activity?
4. What is the relationship between the internal auditors and the audit committee?
5. To whom should the internal auditors report administratively?
6. How is the internal audit activity staffed?
7. How do the internal auditors get and maintain the expertise they need to conduct their assignments?
8. Are the activities of our internal auditors appropriately coordinated with those of the external auditors?
9. How is the internal audit plan developed?
10. What does the internal audit plan not cover?
11. How are internal audit findings reported?
12. How are our corporate managers required to respond to internal audit findings and recommendations?
13. What services do our internal auditors provide regarding fraud?
14. How are we assured of internal audit effectiveness and quality?
15. Does our internal audit activity have sufficient resources?
16. Does our internal audit activity have appropriate support from the CEO and senior management team?
17. Are we satisfied that this organization has adequate internal controls over its major risks?
18. Are there any other matters that should be brought to our attention?
19. Are there other ways in which we and our internal auditors might support each other?
20. Are we satisfied with our internal audit activity?

SOURCE: Adapted from “20 Questions,” originally produced by the Canadian Institute of Chartered Accountants

BEING ON PURPOSE

As a member of the audit committee, you serve as a part of an independent oversight subset of the board of directors. Your role is critical to ensuring the organization has strong and effective processes relating to independence, internal control, risk management, compliance, ethics, and financial disclosures. Working toward goals that are consistent with those of the audit committee, the internal auditors aid in the execution of your committee’s corporate governance responsibilities. In fact, their primary purpose is to help ensure that management and the board meet organizational objectives. To do this, their scope of work should include evaluation of risk in regard to legal and regulatory compliance, conflicts of interest, unethical behavior, and fraudulent activities; and investigation of such initiatives as company whistleblower hotlines.

CHARTING THE COURSE

How does the audit committee go about living up to its significant governance responsibilities, achieving its goals, fulfilling its purpose, and meeting the high expectations of the board of directors, shareholders, and other outside parties?

The audit committee's charter is its blueprint for operations. Highly customized to best meet the needs of an organization's industry, mission, and culture, the charter should clearly delineate audit committee processes, procedures, and responsibilities that have been sanctioned by the entire board. In short, it "charts" the committee's course for the year.

The audit committee charter should define membership requirements, include a provision for a financial expert, allow for

yearly reviews and changes, designate the minimum number of meetings to be conducted, accommodate executive sessions with appropriate entities, and allow for engaging outside counsel as needed. The charter also should outline the committee's responsibilities in regard to risk management, compliance issues, and review of its own effectiveness; identify the specific areas the audit committee should review as well as with whom those reviews will be conducted; and include such specific roles as annual report preparation oversight and yearly agenda planning.

In addition and very important, the charter should delineate the audit committee's relationships with the internal and external auditors, including responsibility for reviewing and concurring on the selection or

dismissal of the CAE; appointing, evaluating, setting time limits for, and discharging (with the concurrence of the full board) the external auditors; and evaluating the independence of both the internal and external auditors.

No sample charter encompasses all activities that might be appropriate to a particular audit committee, nor will all activities identified in a sample charter be relevant to every committee. Accordingly, the following charter is a starting point and can be tailored to any committee's needs and governing rules. It is based on an audit committee charter issues matrix developed for The Institute of Internal Auditors Research Foundation by James Roth, Ph.D., CIA, CCSA, and Donald Espersen, CIA.

SAMPLE AUDIT COMMITTEE CHARTER

PURPOSE

To assist the board of directors in fulfilling its oversight responsibilities for (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors. The audit committee will also prepare the report that regulatory rules require be included in the company's annual proxy statement.

AUTHORITY

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to:

- Appoint, compensate, and oversee the work of the public accounting firm employed by the organization to conduct the annual audit. This firm will report directly to the audit committee.
- Resolve any disagreements between management and the auditor regarding financial reporting.
- Pre-approve all auditing and permitted non-audit services performed by the company's external audit firm.
- Retain independent counsel, accountants, or

others to advise the committee or assist in the conduct of an investigation.

- Seek any information it requires from employees – all of whom are directed to cooperate with the committee's requests – or external parties.
- Meet with company officers, external auditors, or outside counsel, as necessary.
- The committee may delegate authority to subcommittees, including the authority to pre-approve all auditing and permitted non-audit services, providing that such decisions are presented to the full committee at its next scheduled meeting.

COMPOSITION

The audit committee will consist of at least three and no more than six members of the board of directors. The board nominating committee will appoint committee members and the committee chair.

Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation. No committee member shall simultaneously serve on the audit committees of more than two other public companies.

MEETINGS

The committee will meet at least four times a year, with authority to convene additional meetings, as circumstances require. All committee members are expected to attend each meeting, in person or via tele- or video-conference. The committee will invite members of management, auditors or others to attend meetings and provide pertinent information, as necessary. It will meet separately, periodically, with management, with internal auditors and with external auditors. It will also meet periodically in executive session. Meeting agendas will be prepared and provided in advance to members, along with appropriate briefing materials. Minutes will be prepared.

RESPONSIBILITIES

The committee will carry out the following responsibilities:

Financial Statements

- Review significant accounting and reporting issues and understand their impact on the financial statements. These issues include:
 - Complex or unusual transactions and highly judgmental areas
 - Major issues regarding accounting principles and financial statement presentations, including any significant

changes in the company's selection or application of accounting principles

- The effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company.
- Review analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements.
- Review with management and the external auditors the results of the audit, including any difficulties encountered. This review will include any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management.
- Discuss the annual audited financial statements and quarterly financial statements with management and the external auditors, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."
- Review disclosures made by CEO and CFO during the Forms 10-K and 10-Q certification process about significant deficiencies in the design or operation of internal controls or any fraud that involves management or other employees who have a significant role in the company's internal controls.
- Discuss earnings press releases (particularly use of "proforma," or "adjusted" non-GAAP, information), as well as financial information and earnings guidance provided to analysts and rating agencies. This review may be general (i.e., the types of information to be disclosed and the type of presentations to be made). The audit committee does not need to discuss each release in advance.

Internal Control

- Consider the effectiveness of the company's internal control system, including information technology security and control.
- Understand the scope of internal and external auditors' review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal Auditing

- Review with management and the chief audit executive the charter, plans, activities, staffing, and organizational structure of the internal audit function.
- Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.
- Review the effectiveness of the internal audit function, including compliance with The IIA's International Standards for the Professional Practice of Internal Auditing.
- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal auditing believes should be discussed privately.

External Auditing

- Review the external auditors' proposed audit scope and approach, including coordination of audit effort with internal auditing.
- Review the performance of the external auditors, and exercise final approval on the appointment or discharge of the auditors. In performing this review, the committee will:
 - At least annually, obtain and review a report by the independent auditor describing the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review,

or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

- Take into account the opinions of management and internal auditing.
- Review and evaluate the lead partner of the independent auditor.
- Present its conclusions with respect to the external auditor to the board.
- Ensure the rotation of the lead audit partner every five years and other audit partners every seven years, and consider whether there should be regular rotation of the audit firm itself.
- Present its conclusions with respect to the independent auditor to the full board.
- Set clear hiring policies for employees or former employees of the independent auditors.
- On a regular basis, meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately.

Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.
- Establish procedures for: (1) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and (2) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.
- Review the findings of any examinations by regulatory agencies, and any auditor observations.
- Review the process for communicating the code of conduct to company personnel, and for monitoring compliance therewith.
- Obtain regular updates from management and company legal counsel regarding compliance matters.

Reporting Responsibilities

- Regularly report to the board of directors about committee activities and issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, and the performance of the internal audit function.
- Provide an open avenue of communication between internal audit, the external auditors, and the board of directors.
- Report annually to the shareholders, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.
- Review any other reports the company issues that relate to committee responsibilities.

Other Responsibilities

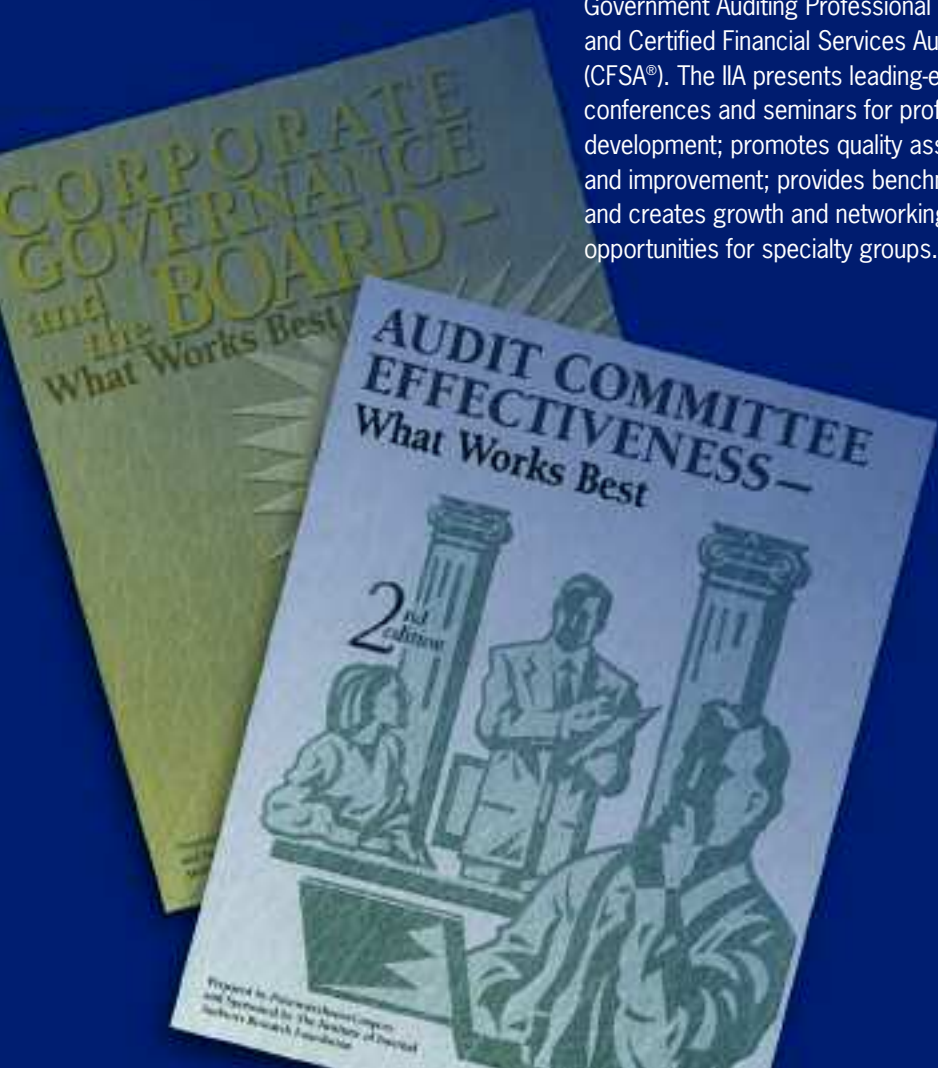
- Discuss with management the company's major policies with respect to risk assessment and risk management.
- Perform other activities related to this charter as requested by the board of directors.
- Institute and oversee special investigations as needed.
- Review and assess the adequacy of the committee charter annually, requesting board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.
- Confirm annually that all responsibilities outlined in this charter have been carried out.
- Evaluate the committee's and individual members' performance at least annually.

THE INSTITUTE OF INTERNAL AUDITORS (IIA) is the acknowledged leader, recognized authority, and chief educator for the profession worldwide. Established in 1941, The IIA has 246 affiliates around the world and serves more than 115,000 members in internal auditing, risk management, governance, internal control, IT audit, education, and security in 160 countries.

The world's leader in certification, education, research, and technical guidance for the profession, The Institute sets the *International Standards for the Professional Practice of Internal Auditing* and provides leading-edge guidance. Serving as internal auditing's global professional association, The IIA certifies professionals through the stringent Certified Internal Auditor® (CIA®) program and specialty certification programs, such as the Certification in Control Self-Assessment (CCSA®), Certified Government Auditing Professional (CGAP®), and Certified Financial Services Auditor® (CFSA®). The IIA presents leading-edge conferences and seminars for professional development; promotes quality assurance and improvement; provides benchmarking; and creates growth and networking opportunities for specialty groups.

The IIA Research Foundation produces forward-thinking educational products and works in partnership with experts from around the globe conducting valuable research projects on the top issues affecting the business world today. The IIA also brings great value to its members through *Internal Auditor*, the award-winning professional magazine, and other outstanding periodicals that address the profession's most pressing issues and challenges and present viable solutions and exemplary practices.

As the global voice of the profession, The IIA promotes quality, professionalism, effective governance, ethical business practices, and world-class internal auditing. Dedicated to providing extensive support and services to help internal auditors add value across the board, The Institute delivers best-practice guidance to internal audit practitioners, executive management, boards of directors, and audit committees all around the world.



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Implementing best practices and high standards



THE AUDIT COMMITTEE: INTERNAL AUDIT OVERSIGHT

ROLES AND RESPONSIBILITIES

AUDIT COMMITTEE RESOURCES

- The Institute of Internal Auditors (IIA)
www.theiia.org
- *Tone at the Top* newsletter from The IIA
www.theiia.org/periodicals/newsletters/ton-at-the-top
- American Institute of Certified Public Accountants (AICPA) Audit Committee Effectiveness Center
www.aicpa.org/audcommctr
- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
www.coso.org
- KPMG's Audit Committee Institute
www.kpmg.com/aci
- Moody's Corporation
www.moody.com
- National Association of Corporate Directors (NACD)
www.nacdonline.org
- The Conference Board
www.conference-board.org

Over the years, the roles and responsibilities of boards of directors — specifically, of the board's audit committee, if in existence — have become increasingly demanding and scrutinized. While today's audit committee must encompass a level of financial literacy, independence, and knowledge about risk management and internal control; individual audit committee members must be deeply committed, highly experienced, and fully qualified in order to effectively carry out their varied responsibilities.

Among the many important roles the audit committee plays within an organization, is to provide internal audit oversight. This document focuses on a single aspect of audit committee performance: its oversight of quality-oriented internal audit activities. While — at first glance — this role might not appear to be terribly complex or time-consuming, further consideration reveals that the

reality is the antithesis of simplicity. And as internal auditing's contribution to effective organizational governance has evolved and become increasingly acknowledged and revered, the audit committee's understanding of internal audit value, processes and procedures, strengths and weaknesses, and potential has escalated exponentially. As such, best practice indicates that the audit committee should define in its charter the scope of its relationship with the internal auditors, and should work to enhance its oversight ability — subsequently strengthening the internal audit activity.

Quality-oriented audit committees beget quality-oriented internal audit activities. But the return on investment goes both ways. The internal auditors also can be an important resource for audit committee enhancement. They do this by reviewing the audit committee charter, providing timely information on new legislation and regulations, and fulfilling the role of educator to audit committee members.



EMPOWERMENT AND EXPECTATIONS

In some organizations, internal auditing is not widely recognized for its invaluable role. It is critical that audit customers throughout the organization understand the value that internal auditors can bring to their operations by identifying opportunities for enhancing efficiencies and effectiveness. The audit committee, in concert with executive management, can play a critical role in empowering and elevating the image of the internal audit activity, ensuring that it is not misunderstood.

By routinely communicating its value throughout the organization, those at the top can and should promote the importance of the internal audit activity. They can position the function as fully empowered to provide a critical check for management, to be a knowledgeable provider of assurance and a revered consultant, and to add value to the organization's governance, risk management, and internal control processes.

10-POINT OVERSIGHT CHECKLIST

TO PROVIDE ADEQUATE OVERSIGHT OF INTERNAL AUDITING,
AN AUDIT COMMITTEE SHOULD ENSURE THE FOLLOWING:

- 1 The audit committee engages in an open, transparent relationship with the chief audit executive (CAE).
- 2 The audit committee reviews and approves the internal audit charter annually.
- 3 As a result of discussions with the CAE, the audit committee has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.
- 4 The internal audit activity is sufficiently resourced with competent, objective internal audit professionals to carry out the internal audit plan, which has been reviewed and approved by the audit committee.
- 5 The internal audit activity is empowered to be independent by its appropriate reporting relationships to executive management and the audit committee.
- 6 The audit committee addresses with the CAE all issues related to internal audit independence and objectivity.
- 7 The internal audit activity is quality-oriented, and has in place a Quality Assurance and Improvement Program.
- 8 The audit committee regularly communicates with the chief audit executive about the performance and improvement of the CAE and the internal audit activity.
- 9 Internal audit reports are actionable, and audit recommendations and/or other improvements are satisfactorily implemented by management.
- 10 The audit committee meets periodically with the CAE without the presence of management.

INTERNAL AUDIT CHARTER

The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* recommend defining the internal audit activity's purpose, authority, and responsibility in a charter that is approved by the board. The internal audit charter is a useful tool for the board and management when evaluating the internal audit activity's performance.



DEFINITION OF INTERNAL AUDITING

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Reporting to executive management and having direct access to the audit committee well positions the internal audit activity within an organization. Internal audit independence is furthered by periodic private meetings between the audit committee and the CAE, during which time sensitive issues are discussed, without management's presence.

SHARING THE VISION

The audit committee and the CAE should agree on the internal audit charter. This requires them to share the same vision in regard to the internal auditors' scope of work, including how their attention and focus will be divided among assurance and consulting; operational, financial, and compliance auditing; and issues related to risk management, internal control, and ethics. This also requires agreement as to the internal auditors' role, as described in The IIA's official definition of internal auditing; as well

PLANNING AHEAD

Although insight provided by the audit committee during the development of the internal audit plan can be invaluable to the internal auditors, a well-developed and implemented plan also can bring great value to the committee in its oversight role. Audit committee members can review the scope, determine whether the internal audit plan addresses previously identified areas of risk, recommend changes to internal audit activities, and determine whether the plan supports the objectives of

BEST PRACTICES < BEST PRACTICES

as ensuring the internal auditors have the authority to access all company employees and to examine all company records and physical assets.

To provide effective internal audit oversight requires the audit committee to have an in-depth understanding of the business, the associated risks, and the internal control environment. The audit committee also must be diligent in reinforcing the importance of internal audit independence, as well as the CAE's accountability to senior management and the audit committee. Once the vision is aligned and the internal audit charter is in place, the audit committee periodically should assess the organizational structure to ensure the internal audit activity has the resources and skill sets necessary to effectively and efficiently accomplish its goals.

management and the board. Once this is determined, a budget must be developed to accommodate the audit plan. The IIA recommends that the budget be reviewed and approved by the audit committee.

COMMUNICATING CRITICAL INFORMATION

Few components of oversight are as critical to effective and successful audit committee oversight of internal auditing as is two-way communication with the internal audit activity. Because of their position and role within an organization, internal auditors possess a good and objective understanding of the culture, system of internal control, operations, and industry. Hence, the audit committee should rely upon them for important information about the organization's control environment and processes, including significant control process issues, potential improvements, and resolution; as well as the overall adequacy of internal controls.

THE AUDIT COMMITTEE: INTERNAL AUDIT OVERSIGHT

Specifically, the audit committee should ensure the lines of communication are open with the internal auditors to discuss significant issues that have been brought to the attention of management and the resulting responses. Should management place limitations on the scope of internal audit processes that have been authorized by the charter, the audit committee should be informed by the CAE. Such discussions will provide valuable information that will help the audit committee in its role of management oversight.

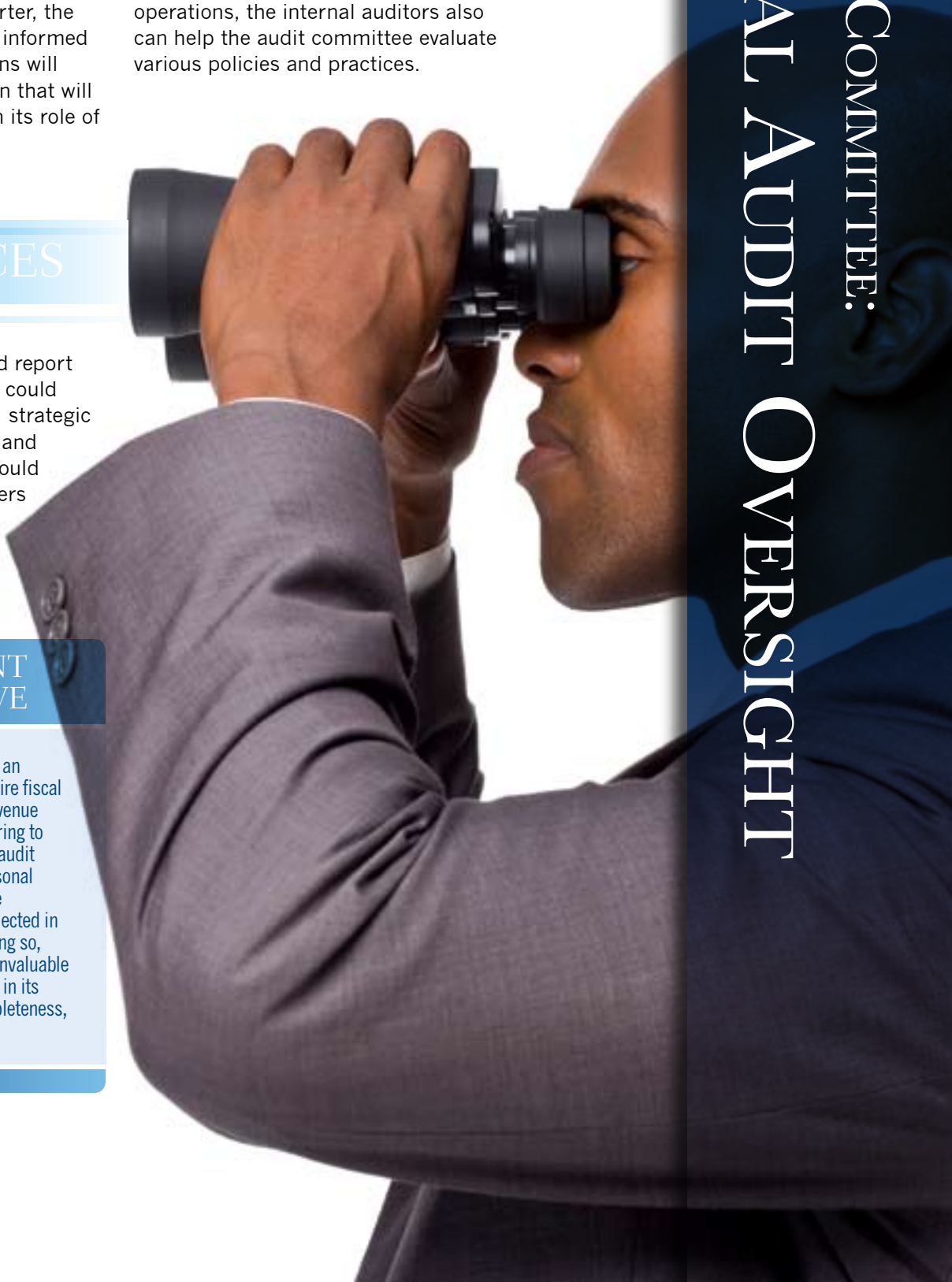
discussion include the reliability of operational information, safeguarding of assets, appropriate disclosures, and compliance with contracts, regulations, and laws. And because of their extensive knowledge and based on their observations of accounting decisions, policies, and any complex or unusual events, transactions, and operations, the internal auditors also can help the audit committee evaluate various policies and practices.

BEST PRACTICES

The internal auditors should report to the committee risks that could hamper the achievement of strategic and operational objectives, and fraud risks that involve or could involve management or others who play a significant role in the internal controls. Other important areas for

A DIFFERENT PERSPECTIVE

Full-time internal auditors have an advantage of witnessing the entire fiscal year with an ongoing view of revenue and expense cycles. They can bring to executive management and the audit committee an up-close and personal perspective on the results of the organization's operations as reflected in the financial statements. By doing so, the internal auditors can be an invaluable resource to the audit committee in its oversight role for financial completeness, accuracy, and disclosure.



QUALITY OF INTERNAL AUDIT PERFORMANCE

OVERSEEING QUALITY

Inherent in the audit committee charter is its responsibility for monitoring and reviewing the performance of the internal audit activity. Because the input of the internal auditors is so critical to the success — and potentially, the very survival — of an organization, it is important for the audit committee to have a clear picture of the internal audit activity's performance, and ensure that it is functioning well.

Clearly, the CAE should report to the audit committee on the performance of the audit plan. But this is not sufficient to ensure quality of the entire internal audit activity. Every internal audit activity, regardless of size, should have in place a Quality Assurance

IMPORTANT QUESTIONS TO ASK

QUESTIONS THAT SHOULD BE ANSWERED IN ORDER TO ADEQUATELY GAUGE AND PROVIDE TO VARIED STAKEHOLDERS REASONABLE ASSURANCE OF INTERNAL AUDIT QUALITY:

- Does the internal audit activity have in place a Quality Assurance and Improvement Program?
- Does the activity have the tools and other resources it needs?
- Has the activity performed its work in accordance with its charter?
- Does the activity engage in ongoing internal reviews and analysis of supervision, documentation, policies, and procedures?
- Do the internal auditors adhere to The IIA's Code of Ethics?
- Does the activity engage in periodic reviews that include customer surveys, risk assessments, work paper reviews, review and analysis of performance metrics, and best-practice benchmarking?
- Are the internal audits conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*?
- Do members of the team participate in professional development training?
- Does the activity operate effectively and efficiently?
- Have team members acquired professional designations that demonstrate their competency?
- Is the staff size adequate?
- Are the existing skill sets appropriate?
- Does the activity contribute to the improvement of organizational operations, and is it perceived by stakeholders to add value?
- Has the internal audit activity obtained an independent external quality assessment within the past five years?

SETTING THE STANDARD

As the internal audit profession's trustworthy global guidance-setting body, The Institute of Internal Auditors (IIA) promulgates the *International Standards for the Professional Practice of Internal Auditing (Standards)*. Professional internal audit activities work in conformance with the *Standards*, which — along with the Definition of Internal Auditing and the Code of Ethics — are a mandatory component of the International Professional Practice Framework (IPPF). Included in the *Standards* is a mandate for internal audit activities to obtain an external quality assessment every five years.

and Improvement Program. Not only does such a program help ensure the activity is on the path to optimal quality, but it also sets an example of excellence for all audit customers and stakeholders, by demonstrating the activity's commitment to confronting areas in need of improvement, and taking steps to make the requisite changes.

AUDITING THE INTERNAL AUDITORS

The internal audit activity is a part of an organization's risk universe,

and should be assessed. Although the audit committee clearly is responsible for internal audit oversight, it is not the committee's role to "audit" the activity. The audit committee's oversight is at a much higher level. So who audits the internal auditors? That is the role of the external quality assessment (QA) team — an independent group of professionals who are well-versed in best internal audit practices, under the leadership of an experienced and professional project manager.

The objectives of an external QA team are to evaluate the efficiency and effectiveness of the internal audit activity within the organization, to make best-practice recommendations for improvement, and to determine whether the activity is in conformance with the *Standards*. This is especially important, as it sends the message to everyone that the internal audit activity systematically submits itself to the same level of scrutiny that the rest of the organization undergoes through internal audits. This represents the internal audit activity's commitment to excellence and dedication to quality.

In addition, the external QA validates — for the CAE, executive management, and the audit committee — the level of the internal audit activity's performance. It also provides assurance that enables the audit committee to report to the board with the highest level of confidence that internal auditing is functioning as it should.

REST ASSURED

The CAE's reports on the status of the activity's Quality Assurance and Improvement Program should provide to the audit committee assurance of the internal audit activity's quality. This assurance is derived from a variety of sources:

- Internal assessments — periodic and ongoing feedback on what's working and what gaps need to be filled to ensure effectiveness, efficiency, economy, and conformance with the *Standards*.

QUALITY RESOURCES

On The IIA's Web site at www.theiia.org/quality are a variety of resources for improving quality internal auditing, including a Quality Maturity Model and overview of what is entailed in a Quality Assurance and Improvement Program. "The Path to Quality" provides a step-by-step guide for getting to the next level.

- Action plans — documenting action needed and steps taken to fix issues and align goals and objectives in a changing environment with competing priorities.
- External QAs — independent validation that what you are hearing from the CAE about the activity is accurate.
- External auditors — the level to which they are comfortable relying on the work of the internal audit activity.

By establishing an open and trusting relationship with the CAE, clearly delineating your expectations of the internal auditors, being attentive to all reports provided, and asking the right questions, you and the entire audit committee can stay up to date on the internal audit activity. Following these practices will help ensure that the CAE has the tools, resources, and support necessary for optimal performance. It also will help keep you informed about the quality of your internal audit activity. And when it comes to effective organizational governance and oversight, this level of knowledge will go a long way toward ensuring you don't lie awake worrying at night!

BENEFITS OF EXTERNAL QUALITY ASSESSMENTS

As the internal audit profession's recognized authority, The IIA promulgates the accepted global methodology for assessing internal audit quality. The IIA also provides cost-effective external QA services to help organizations validate and strengthen their internal audit activities, and enhance their effectiveness, efficiency, and best-practice implementation.

In addition to ensuring the internal audit activity's conformance with the *International Standards for the Professional Practice of Internal Auditing*, the benefits of external quality assessments are well documented.

JCPENNEY

"Additional benefits qualified external parties can bring to your audit function include experiences, leading practices, and value-added processes they have been exposed to as a result of conducting QAs for other internal audit shops."

MERCK & CO.

"External quality assessments provide ... a critical opportunity to benchmark Merck against other companies following the same standards and guidelines."

CHINA NATIONAL OFFSHORE OIL COMPANY AND SHELL PETROCHEMICALS CO. LTD. (CSPC)

"Through the QA process ... we have embedded quality into the mindset and daily operations of our internal audit activity, and the company as a whole."

POST DENMARK

"We received great benefit from having an independent validator from The IIA challenging us on our processes. Moreover, the validator facilitated fruitful discussions with executive management and the chairman of the board on the role of our function."

GRUPO BANCOLOMBIA

"External quality assessments have been crucial in our continuous improvement process."

DELL INC.

"Quality assessment programs are foundational to performing and sustaining high-quality production."

DYNEGY, INC.

"To really benefit from a QA ... it is important to acknowledge your identified shortcomings and develop and implement plans to rectify them."

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INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING (STANDARDS)

Introduction to the *Standards*

Internal auditing is conducted in diverse legal and cultural environments; for organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, conformance with The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* is essential in meeting the responsibilities of internal auditors and the internal audit activity.

The purpose of the *Standards* is to:

1. Guide adherence with the mandatory elements of the International Professional Practices Framework.
2. Provide a framework for performing and promoting a broad range of value-added internal auditing services.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational processes and operations.

The *Standards* are a set of principles-based, mandatory requirements consisting of:

- Statements of core requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance that are internationally applicable at organizational and individual levels.
- Interpretations clarifying terms or concepts within the *Standards*.

The *Standards*, together with the Code of Ethics, encompass all mandatory elements of the International Professional Practices Framework; therefore, conformance with the Code of Ethics and the *Standards* demonstrates conformance with all mandatory elements of the International Professional Practices Framework.

The *Standards* employ terms as defined specifically in the Glossary. To understand and apply the *Standards* correctly, it is necessary to consider the specific meanings from the Glossary. Furthermore, the *Standards* use the word “must” to specify an unconditional requirement and the word “should” where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

The *Standards* comprise two main categories: Attribute and Performance Standards. Attribute Standards address the attributes of organizations and individuals performing internal auditing. Performance Standards describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured. Attribute and Performance Standards apply to all internal audit services.

Implementation Standards expand upon the Attribute and Performance Standards by providing the requirements applicable to assurance (.A) or consulting (.C) services.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Assurance services involve the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding an entity, operation, function, process, system, or other subject matters. The nature and scope of an assurance engagement are determined by the internal auditor. Generally, three parties are participants in assurance services: (1) the person or group directly involved with the entity, operation, function, process, system, or other subject matter — the process owner, (2) the person or group making the assessment — the internal auditor, and (3) the person or group using the assessment — the user.

Consulting services are advisory in nature and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice — the internal auditor, and (2) the person or group seeking and receiving the advice — the engagement client. When performing consulting services the internal auditor should maintain objectivity and not assume management responsibility.

The *Standards* apply to individual internal auditors and the internal audit activity. All internal auditors are accountable for conforming with the standards related to individual objectivity, proficiency, and due professional care and the standards relevant to the performance of their job responsibilities. Chief audit executives are additionally accountable for the internal audit activity's overall conformance with the *Standards*.

If internal auditors or the internal audit activity is prohibited by law or regulation from conformance with certain parts of the *Standards*, conformance with all other parts of the *Standards* and appropriate disclosures are needed.

If the *Standards* are used in conjunction with requirements issued by other authoritative bodies, internal audit communications may also cite the use of other requirements, as appropriate. In such a case, if the internal audit activity indicates conformance with the *Standards* and inconsistencies exist between the *Standards* and other requirements, internal auditors and the internal audit activity must conform with the *Standards* and may conform with the other requirements if such requirements are more restrictive.

The review and development of the *Standards* is an ongoing process. The International Internal Audit Standards Board engages in extensive consultation and discussion before issuing the *Standards*. This includes worldwide solicitation for public comment through the exposure draft process. All exposure drafts are posted on The IIA's website as well as being distributed to all IIA institutes.

Suggestions and comments regarding the *Standards* can be sent to:

The Institute of Internal Auditors
Standards and Guidance
1035 Greenwood Blvd, Suite 401
Lake Mary, FL 32746 USA

E-mail: guidance@theiia.org

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***INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF
INTERNAL AUDITING (STANDARDS)***

Attribute Standards

1000 – Purpose, Authority, and Responsibility

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework (the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing). The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

Interpretation:

The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.

1000.A1 – The nature of assurance services provided to the organization must be defined in the internal audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances must also be defined in the internal audit charter.

1000.C1 – The nature of consulting services must be defined in the internal audit charter.

1010 – Recognizing Mandatory Guidance in the Internal Audit Charter

The mandatory nature of the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing must be recognized in the internal audit charter. The chief audit executive should discuss the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework with senior management and the board.

1100 – Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Interpretation:

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board.

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This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

1110 – Organizational Independence

The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

Interpretation:

Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board:

- *Approving the internal audit charter.*
- *Approving the risk-based internal audit plan.*
- *Approving the internal audit budget and resource plan.*
- *Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters.*
- *Approving decisions regarding the appointment and removal of the chief audit executive.*
- *Approving the remuneration of the chief audit executive.*
- *Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.*

1110.A1 – The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results. The chief audit executive must disclose such interference to the board and discuss the implications.

1111 – Direct Interaction with the Board

The chief audit executive must communicate and interact directly with the board.

1112 – Chief Audit Executive Roles Beyond Internal Auditing

Where the chief audit executive has or is expected to have roles and/or responsibilities that fall outside of internal auditing, safeguards must be in place to limit impairments to independence or objectivity.

Interpretation:

The chief audit executive may be asked to take on additional roles and responsibilities outside of internal auditing, such as responsibility for compliance or risk management activities. These roles and responsibilities may impair, or appear to impair, the organizational independence of the

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internal audit activity or the individual objectivity of the internal auditor. Safeguards are those oversight activities, often undertaken by the board, to address these potential impairments, and may include such activities as periodically evaluating reporting lines and responsibilities and developing alternative processes to obtain assurance related to the areas of additional responsibility.

1120 – Individual Objectivity

Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

Interpretation:

Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.

1130 – Impairment to Independence or Objectivity

If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

Interpretation:

Impairment to organizational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding.

The determination of appropriate parties to which the details of an impairment to independence or objectivity must be disclosed is dependent upon the expectations of the internal audit activity's and the chief audit executive's responsibilities to senior management and the board as described in the internal audit charter, as well as the nature of the impairment.

1130.A1 – Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

1130.A2 – Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.

1130.A3 – The internal audit activity may provide assurance services where it had previously performed consulting services, provided the nature of the consulting did not impair objectivity and provided individual objectivity is managed when assigning resources to the engagement.

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1130.C1 – Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130.C2 – If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement.

1200 – Proficiency and Due Professional Care

Engagements must be performed with proficiency and due professional care.

1210 – Proficiency

Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

Interpretation:

Proficiency is a collective term that refers to the knowledge, skills, and other competencies required of internal auditors to effectively carry out their professional responsibilities. It encompasses consideration of current activities, trends, and emerging issues, to enable relevant advice and recommendations. Internal auditors are encouraged to demonstrate their proficiency by obtaining appropriate professional certifications and qualifications, such as the Certified Internal Auditor designation and other designations offered by The Institute of Internal Auditors and other appropriate professional organizations.

1210.A1 – The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2 – Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210.A3 – Internal auditors must have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1 – The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220 – Due Professional Care

Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

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1220.A1 – Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement’s objectives.
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied.
- Adequacy and effectiveness of governance, risk management, and control processes.
- Probability of significant errors, fraud, or noncompliance.
- Cost of assurance in relation to potential benefits.

1220.A2 – In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques.

1220.A3 – Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1 – Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results.
- Relative complexity and extent of work needed to achieve the engagement’s objectives.
- Cost of the consulting engagement in relation to potential benefits.

1230 – Continuing Professional Development

Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

1300 – Quality Assurance and Improvement Program

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

Interpretation:

A quality assurance and improvement program is designed to enable an evaluation of the internal audit activity’s conformance with the Standards and an evaluation of whether internal auditors apply the Code of Ethics. The program also assesses the efficiency and effectiveness of the internal audit activity and identifies opportunities for improvement. The chief audit executive should encourage board oversight in the quality assurance and improvement program.

1310 – Requirements of the Quality Assurance and Improvement Program

The quality assurance and improvement program must include both internal and external assessments.

1311 – Internal Assessments

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Internal assessments must include:

- Ongoing monitoring of the performance of the internal audit activity.
- Periodic self-assessments or assessments by other persons within the organization with sufficient knowledge of internal audit practices.

Interpretation:

Ongoing monitoring is an integral part of the day-to-day supervision, review, and measurement of the internal audit activity. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity and uses processes, tools, and information considered necessary to evaluate conformance with the Code of Ethics and the Standards.

Periodic assessments are conducted to evaluate conformance with the Code of Ethics and the Standards.

Sufficient knowledge of internal audit practices requires at least an understanding of all elements of the International Professional Practices Framework.

1312 – External Assessments

External assessments must be conducted at least once every five years by a qualified, independent assessor or assessment team from outside the organization. The chief audit executive must discuss with the board:

- The form and frequency of external assessment.
- The qualifications and independence of the external assessor or assessment team, including any potential conflict of interest.

Interpretation:

External assessments may be accomplished through a full external assessment, or a self-assessment with independent external validation. The external assessor must conclude as to conformance with the Code of Ethics and the Standards; the external assessment may also include operational or strategic comments.

A qualified assessor or assessment team demonstrates competence in two areas: the professional practice of internal auditing and the external assessment process. Competence can be demonstrated through a mixture of experience and theoretical learning. Experience gained in organizations of similar size, complexity, sector or industry, and technical issues is more valuable than less relevant experience. In the case of an assessment team, not all members of the team need to have all the competencies; it is the team as a whole that is qualified. The chief audit executive uses professional judgment when assessing whether an assessor or assessment team demonstrates sufficient competence to be qualified.

An independent assessor or assessment team means not having either an actual or a perceived conflict of interest and not being a part of, or under the control of, the organization to which the internal audit activity belongs. The chief audit executive should encourage board oversight in the external assessment to reduce perceived or potential conflicts of interest.

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1320 – Reporting on the Quality Assurance and Improvement Program

The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board. Disclosure should include:

- The scope and frequency of both the internal and external assessments.
- The qualifications and independence of the assessor(s) or assessment team, including potential conflicts of interest.
- Conclusions of assessors.
- Corrective action plans.

Interpretation:

The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter. To demonstrate conformance with the Code of Ethics and the Standards, the results of external and periodic internal assessments are communicated upon completion of such assessments, and the results of ongoing monitoring are communicated at least annually. The results include the assessor's or assessment team's evaluation with respect to the degree of conformance.

1321 – Use of “Conforms with the *International Standards for the Professional Practice of Internal Auditing*”

Indicating that the internal audit activity conforms with the *International Standards for the Professional Practice of Internal Auditing* is appropriate only if supported by the results of the quality assurance and improvement program.

Interpretation:

The internal audit activity conforms with the Code of Ethics and the Standards when it achieves the outcomes described therein. The results of the quality assurance and improvement program include the results of both internal and external assessments. All internal audit activities will have the results of internal assessments. Internal audit activities in existence for at least five years will also have the results of external assessments.

1322 – Disclosure of Nonconformance

When nonconformance with the Code of Ethics or the *Standards* impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Performance Standards

2000 – Managing the Internal Audit Activity

The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

Interpretation:

The internal audit activity is effectively managed when:

- *It achieves the purpose and responsibility included in the internal audit charter.*
- *It conforms with the Standards.*
- *Its individual members conform with the Code of Ethics and the Standards.*
- *It considers trends and emerging issues that could impact the organization.*

The internal audit activity adds value to the organization and its stakeholders when it considers strategies, objectives, and risks; strives to offer ways to enhance governance, risk management, and control processes; and objectively provides relevant assurance.

2010 – Planning

The chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.

Interpretation:

To develop the risk-based plan, the chief audit executive consults with senior management and the board and obtains an understanding of the organization's strategies, key business objectives, associated risks, and risk management processes. The chief audit executive must review and adjust the plan, as necessary, in response to changes in the organization's business, risks, operations, programs, systems, and controls.

2010.A1 – The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

2010.A2 – The chief audit executive must identify and consider the expectations of senior management, the board, and other stakeholders for internal audit opinions and other conclusions.

2010.C1 – The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Accepted engagements must be included in the plan.

2020 – Communication and Approval

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The chief audit executive must communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. The chief audit executive must also communicate the impact of resource limitations.

2030 – Resource Management

The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Interpretation:

Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the plan. Sufficient refers to the quantity of resources needed to accomplish the plan. Resources are effectively deployed when they are used in a way that optimizes the achievement of the approved plan.

2040 – Policies and Procedures

The chief audit executive must establish policies and procedures to guide the internal audit activity.

Interpretation:

The form and content of policies and procedures are dependent upon the size and structure of the internal audit activity and the complexity of its work.

2050 – Coordination and Reliance

The chief audit executive should share information, coordinate activities, and consider relying upon the work of other internal and external assurance and consulting service providers to ensure proper coverage and minimize duplication of efforts.

Interpretation:

In coordinating activities, the chief audit executive may rely on the work of other assurance and consulting service providers. A consistent process for the basis of reliance should be established, and the chief audit executive should consider the competency, objectivity, and due professional care of the assurance and consulting service providers. The chief audit executive should also have a clear understanding of the scope, objectives, and results of the work performed by other providers of assurance and consulting services. Where reliance is placed on the work of others, the chief audit executive is still accountable and responsible for ensuring adequate support for conclusions and opinions reached by the internal audit activity.

2060 – Reporting to Senior Management and the Board

The chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan and on its conformance with the Code of Ethics and the *Standards*. Reporting must also include

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significant risk and control issues, including fraud risks, governance issues, and other matters that require the attention of senior management and/or the board.

Interpretation:

The frequency and content of reporting are determined collaboratively by the chief audit executive, senior management, and the board. The frequency and content of reporting depends on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management and/or the board.

The chief audit executive's reporting and communication to senior management and the board must include information about:

- *The audit charter.*
- *Independence of the internal audit activity.*
- *The audit plan and progress against the plan.*
- *Resource requirements.*
- *Results of audit activities.*
- *Conformance with the Code of Ethics and the Standards, and action plans to address any significant conformance issues.*
- *Management's response to risk that, in the chief audit executive's judgment, may be unacceptable to the organization.*

These and other chief audit executive communication requirements are referenced throughout the Standards.

2070 – External Service Provider and Organizational Responsibility for Internal Auditing

When an external service provider serves as the internal audit activity, the provider must make the organization aware that the organization has the responsibility for maintaining an effective internal audit activity.

Interpretation:

This responsibility is demonstrated through the quality assurance and improvement program which assesses conformance with the Code of Ethics and the Standards.

2100 – Nature of Work

The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management, and control processes using a systematic, disciplined, and risk-based approach. Internal audit credibility and value are enhanced when auditors are proactive and their evaluations offer new insights and consider future impact.

2110 – Governance

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for:

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- Making strategic and operational decisions.
- Overseeing risk management and control.
- Promoting appropriate ethics and values within the organization.
- Ensuring effective organizational performance management and accountability.
- Communicating risk and control information to appropriate areas of the organization.
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management.

2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.

2110.A2 – The internal audit activity must assess whether the information technology governance of the organization supports the organization’s strategies and objectives.

2120 – Risk Management

The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

Interpretation:

Determining whether risk management processes are effective is a judgment resulting from the internal auditor’s assessment that:

- *Organizational objectives support and align with the organization’s mission.*
- *Significant risks are identified and assessed.*
- *Appropriate risk responses are selected that align risks with the organization’s risk appetite.*
- *Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.*

The internal audit activity may gather the information to support this assessment during multiple engagements. The results of these engagements, when viewed together, provide an understanding of the organization’s risk management processes and their effectiveness.

Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

2120.A1 – The internal audit activity must evaluate risk exposures relating to the organization’s governance, operations, and information systems regarding the:

- Achievement of the organization’s strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

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2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

2120.C1 – During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2120.C2 – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organization's risk management processes.

2120.C3 – When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.

2130 – Control

The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130.A1 – The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations, and information systems regarding the:

- Achievement of the organization's strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

2130.C1 – Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organization's control processes.

2200 – Engagement Planning

Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing, and resource allocations. The plan must consider the organization's strategies, objectives, and risks relevant to the engagement.

2201 – Planning Considerations

In planning the engagement, internal auditors must consider:

- The strategies and objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity's objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity's governance, risk management, and control processes compared to a relevant framework or model.
- The opportunities for making significant improvements to the activity's governance, risk management, and control processes.

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2201.A1 – When planning an engagement for parties outside the organization, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1 – Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding must be documented.

2210 – Engagement Objectives

Objectives must be established for each engagement.

2210.A1 – Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.

2210.A2 – Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.

2210.A3 – Adequate criteria are needed to evaluate governance, risk management, and controls. Internal auditors must ascertain the extent to which management and/or the board has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must identify appropriate evaluation criteria through discussion with management and/or the board.

Interpretation:

Types of criteria may include:

- *Internal (e.g., policies and procedures of the organization).*
- *External (e.g., laws and regulations imposed by statutory bodies).*
- *Leading practices (e.g., industry and professional guidance).*

2210.C1 – Consulting engagement objectives must address governance, risk management, and control processes to the extent agreed upon with the client.

2210.C2 – Consulting engagement objectives must be consistent with the organization's values, strategies, and objectives.

2220 – Engagement Scope

The established scope must be sufficient to achieve the objectives of the engagement.

2220.A1 – The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

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2220.A2 – If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities, and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

2220.C1 – In performing consulting engagements, internal auditors must ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with the engagement.

2220.C2 – During consulting engagements, internal auditors must address controls consistent with the engagement's objectives and be alert to significant control issues.

2230 – Engagement Resource Allocation

Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.

Interpretation:

Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the engagement. Sufficient refers to the quantity of resources needed to accomplish the engagement with due professional care.

2240 – Engagement Work Program

Internal auditors must develop and document work programs that achieve the engagement objectives.

2240.A1 – Work programs must include the procedures for identifying, analyzing, evaluating, and documenting information during the engagement. The work program must be approved prior to its implementation, and any adjustments approved promptly.

2240.C1 – Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement

Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.

2310 – Identifying Information

Internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

Interpretation:

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Sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor. Reliable information is the best attainable information through the use of appropriate engagement techniques. Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement. Useful information helps the organization meet its goals.

2320 – Analysis and Evaluation

Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Documenting Information

Internal auditors must document sufficient, reliable, relevant, and useful information to support the engagement results and conclusions.

2330.A1 – The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2 – The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2330.C1 – The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2340 – Engagement Supervision

Engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

Interpretation:

The extent of supervision required will depend on the proficiency and experience of internal auditors and the complexity of the engagement. The chief audit executive has overall responsibility for supervising the engagement, whether performed by or for the internal audit activity, but may designate appropriately experienced members of the internal audit activity to perform the review. Appropriate evidence of supervision is documented and retained.

2400 – Communicating Results

Internal auditors must communicate the results of engagements.

2410 – Criteria for Communicating

International Standards for the Professional Practice of Internal Auditing (Standards)

Communications must include the engagement's objectives, scope, and results.

2410.A1 – Final communication of engagement results must include applicable conclusions, as well as applicable recommendations and/or action plans. Where appropriate, the internal auditors' opinion should be provided. An opinion must take into account the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Interpretation:

Opinions at the engagement level may be ratings, conclusions, or other descriptions of the results. Such an engagement may be in relation to controls around a specific process, risk, or business unit. The formulation of such opinions requires consideration of the engagement results and their significance.

2410.A2 – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3 – When releasing engagement results to parties outside the organization, the communication must include limitations on distribution and use of the results.

2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420 – Quality of Communications

Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

Interpretation:

Accurate communications are free from errors and distortions and are faithful to the underlying facts. Objective communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances. Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness. Constructive communications are helpful to the engagement client and the organization and lead to improvements where needed. Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. Timely communications are opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

2421 – Errors and Omissions

If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.

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2430 – Use of “Conducted in Conformance with the *International Standards for the Professional Practice of Internal Auditing*”

Indicating that engagements are “conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*” is appropriate only if supported by the results of the quality assurance and improvement program.

2431 – Engagement Disclosure of Nonconformance

When nonconformance with the Code of Ethics or the *Standards* impacts a specific engagement, communication of the results must disclose the:

- Principle(s) or rule(s) of conduct of the Code of Ethics or the Standard(s) with which full conformance was not achieved.
- Reason(s) for nonconformance.
- Impact of nonconformance on the engagement and the communicated engagement results.

2440 – Disseminating Results

The chief audit executive must communicate results to the appropriate parties.

Interpretation:

The chief audit executive is responsible for reviewing and approving the final engagement communication before issuance and for deciding to whom and how it will be disseminated. When the chief audit executive delegates these duties, he or she retains overall responsibility.

2440.A1 – The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2 – If not otherwise mandated by legal, statutory, or regulatory requirements, prior to releasing results to parties outside the organization the chief audit executive must:

- Assess the potential risk to the organization.
- Consult with senior management and/or legal counsel as appropriate.
- Control dissemination by restricting the use of the results.

2440.C1 – The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2 – During consulting engagements, governance, risk management, and control issues may be identified. Whenever these issues are significant to the organization, they must be communicated to senior management and the board.

2450 – Overall Opinions

When an overall opinion is issued, it must take into account the strategies, objectives, and risks of the organization; and the expectations of senior management, the board, and other

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stakeholders. The overall opinion must be supported by sufficient, reliable, relevant, and useful information.

Interpretation:

The communication will include:

- *The scope, including the time period to which the opinion pertains.*
- *Scope limitations.*
- *Consideration of all related projects, including the reliance on other assurance providers.*
- *A summary of the information that supports the opinion.*
- *The risk or control framework or other criteria used as a basis for the overall opinion.*
- *The overall opinion, judgment, or conclusion reached.*

The reasons for an unfavorable overall opinion must be stated.

2500 – Monitoring Progress

The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

2500.A1 – The chief audit executive must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

2500.C1 – The internal audit activity must monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Communicating the Acceptance of Risks

When the chief audit executive concludes that management has accepted a level of risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the chief audit executive determines that the matter has not been resolved, the chief audit executive must communicate the matter to the board.

Interpretation:

The identification of risk accepted by management may be observed through an assurance or consulting engagement, monitoring progress on actions taken by management as a result of prior engagements, or other means. It is not the responsibility of the chief audit executive to resolve the risk.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Glossary

Add Value

The internal audit activity adds value to the organization (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

Adequate Control

Present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organization's risks have been managed effectively and that the organization's goals and objectives will be achieved efficiently and economically.

Assurance Services

An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.

Board

The highest level governing body (e.g., a board of directors, a supervisory board, or a board of governors or trustees) charged with the responsibility to direct and/or oversee the organization's activities and hold senior management accountable. Although governance arrangements vary among jurisdictions and sectors, typically the board includes members who are not part of management. If a board does not exist, the word "board" in the *Standards* refers to a group or person charged with governance of the organization. Furthermore, "board" in the *Standards* may refer to a committee or another body to which the governing body has delegated certain functions (e.g., an audit committee).

Charter

The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities.

Chief Audit Executive

Chief audit executive describes the role of a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the International Professional Practices Framework. The chief audit executive or others reporting to the chief audit executive will have appropriate professional certifications and qualifications. The specific job title and/or responsibilities of the chief audit executive may vary across organizations.

Code of Ethics

The Code of Ethics of The Institute of Internal Auditors (IIA) are Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Compliance

Adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

Conflict of Interest

Any relationship that is, or appears to be, not in the best interest of the organization. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.

Consulting Services

Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organization's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.

Control

Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Control Environment

The attitude and actions of the board and management regarding the importance of control within the organization. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.
- Competence of personnel.

Control Processes

The policies, procedures (both manual and automated), and activities that are part of a control framework, designed and operated to ensure that risks are contained within the level that an organization is willing to accept.

Core Principles for the Professional Practice of Internal Auditing

The Core Principles for the Professional Practice of Internal Auditing are the foundation for the International Professional Practices Framework and support internal audit effectiveness.

Engagement

A specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Engagement Objectives

Broad statements developed by internal auditors that define intended engagement accomplishments.

Engagement Opinion

The rating, conclusion, and/or other description of results of an individual internal audit engagement, relating to those aspects within the objectives and scope of the engagement.

Engagement Work Program

A document that lists the procedures to be followed during an engagement, designed to achieve the engagement plan.

External Service Provider

A person or firm outside of the organization that has special knowledge, skill, and experience in a particular discipline.

Fraud

Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Governance

The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

Impairment

Impairment to organizational independence and individual objectivity may include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).

Independence

The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

Information Technology Controls

Controls that support business management and governance as well as provide general and technical controls over information technology infrastructures such as applications, information, infrastructure, and people.

Information Technology Governance

Consists of the leadership, organizational structures, and processes that ensure that the enterprise's information technology supports the organization's strategies and objectives.

Internal Audit Activity

A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes.

International Standards for the Professional Practice of Internal Auditing (*Standards*)

International Professional Practices Framework

The conceptual framework that organizes the authoritative guidance promulgated by The IIA. Authoritative guidance is composed of two categories – (1) mandatory and (2) recommended.

Must

The *Standards* use the word “must” to specify an unconditional requirement.

Objectivity

An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.

Overall Opinion

The rating, conclusion, and/or other description of results provided by the chief audit executive addressing, at a broad level, governance, risk management, and/or control processes of the organization. An overall opinion is the professional judgment of the chief audit executive based on the results of a number of individual engagements and other activities for a specific time interval.

Risk

The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

Risk Appetite

The level of risk that an organization is willing to accept.

Risk Management

A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization’s objectives.

Should

The *Standards* use the word “should” where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

Significance

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors, such as magnitude, nature, effect, relevance, and impact. Professional judgment assists internal auditors when evaluating the significance of matters within the context of the relevant objectives.

Standard

A professional pronouncement promulgated by the International Internal Audit Standards Board that delineates the requirements for performing a broad range of internal audit activities and for evaluating internal audit performance.

Technology-based Audit Techniques

Any automated audit tool, such as generalized audit software, test data generators, computerized audit programs, specialized audit utilities, and computer-assisted audit techniques (CAATs).

International Standards for the Professional Practice of Internal Auditing (*Standards*)

Government Finance Officers Association (GFOA)

(Guidance)



BEST PRACTICE

Audit Committees

BACKGROUND:

Three main groups are responsible for the quality of financial reporting: the governing body,¹ financial management, and the independent auditors. Of these three, the governing body must be seen as first among equals because of its unique position as the ultimate monitor of the financial reporting process.² An audit committee is a practical means for a governing body to provide much needed independent review and oversight of the governments financial reporting processes, internal controls, and independent auditors. An audit committee also provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, an audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess managements practices, and that the independent auditors, through their own review, objectively assess the governments financial reporting practices.³

RECOMMENDATION:

GFOA makes the following recommendations regarding the establishment of audit committees by state and local governments:

- The governing body⁴ of every state and local government should establish an audit committee or its equivalent;
- The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means and made directly responsible⁵ for the appointment, compensation, retention, and oversight of the work of any independent accountants engaged for the purpose of preparing or issuing an independent audit report or performing other independent audit, review, or attest services.⁶ Likewise, the audit committee should be established in such a manner that all accountants thus engaged report directly to the audit committee. The written documentation establishing the audit committee should prescribe the scope of the committees responsibilities, as well as its structure, processes, and membership requirements. The audit committee should itself periodically review such documentation, no less than once every five years, to assess its continued adequacy;⁷
- Ideally, all members of the audit committee should possess or obtain a basic understanding of governmental financial reporting and auditing.⁸ The audit committee also should have access to the services of at least one financial expert, either a committee member or an outside party engaged by the committee for this purpose. Such a financial expert should through both education and experience, and in a manner specifically relevant to the government sector, possess 1) an understanding of generally accepted accounting principles and financial statements; 2) experience in preparing or auditing financial statements of comparable entities; 3) experience in applying such principles in connection with the

accounting for estimates, accruals, and reserves; 4) experience with internal accounting controls; and 5) an understanding of audit committee functions;⁹

- All members of the audit committee should be members of the governing body. To ensure the committees independence and effectiveness, no governing body member who exercises managerial responsibilities that fall within the scope of the audit should serve as a member of the audit committee;
- An audit committee should have sufficient members for meaningful discussion and deliberation, but not so many as to impede its efficient operation. As a general rule, the minimum membership of the committee should be no fewer than three;¹⁰
- Members of the audit committee should be educated regarding both the role of the audit committee and their personal responsibility as members, including their duty to exercise an appropriate degree of professional skepticism;
- It is the responsibility of the audit committee to provide independent review and oversight of a governments financial reporting processes, internal controls and independent auditors;¹¹
- The audit committee should have access to the reports of internal auditors, as well as access to annual internal audit work plans;
- The audit committee should present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public and be accompanied by the audit committees charter or other establishing documentation;
- The audit committee should establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters. Such procedures should specifically provide for the confidential, anonymous submission by employees of the government of concerns regarding questionable accounting or auditing matters.¹² The audit committee also should monitor controls performed directly by senior management, as well as controls designed to prevent or detect senior-management override of other controls¹³;
- The audit committee should be adequately funded and should be authorized to engage the services of financial experts, legal counsel, and other appropriate specialists, as necessary to fulfill its responsibilities¹⁴; and
- In its report to the governing body, the audit committee should specifically state that it has discussed the financial statements with management, with the independent auditors in private,¹⁵ and privately among committee members,¹⁶ and believes that they are fairly presented, to the extent such a determination can be made solely on the basis of such conversations.

Notes:

¹ For the purposes of this recommended practice, the term governing body should be understood to include any elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do not exercise managerial responsibilities within the scope of the audit. The term governing body also is intended to encompass appointed bodies such as pension boards.

² *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, Overview and Recommendations.

³ Securities and Exchange Commission (SEC) Regulation 33-8220, Background and Overview of the New Rule and Amendments.

⁴ For the purposes of this recommended practice, the term governing body should be understood to include any other elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do *not* exercise managerial responsibilities within the scope of the audit. The term governing body also is intended to encompass appointed bodies such as pension boards.

⁵ Nothing in this recommended practice should be interpreted so as to limit the full governing body from exercising ultimate authority.

⁶ Sarbanes Oxley Act, Section 301.

⁷ *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, Recommendation 4.

⁸ *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, Recommendation 3. Continuity typically is a positive factor in achieving this goal, a fact that should be kept in mind when considering the appropriate length of service for audit committee members.

⁹ Sarbanes-Oxley Act, Section 407.

¹⁰ In certain limited instances, as noted later, the audit committee will need to meet privately to achieve its goals. If the audit committee constitutes a majority of the governing body, such private meetings may be hampered by sunshine laws and similar open meetings legislation.

¹¹ SEC Regulation 330-8220, Background and Overview.

¹² Sarbanes Oxley Act, Section 301.

¹³ *Internal Control Integrated Framework: Guidance on Monitoring Internal Control Systems* (Discussion Document of the Committee of Sponsoring Organizations COSO, 2007), page 10.

¹⁴ Nothing in this recommended practice should be interpreted so as to limit the full governing body from exercising ultimate authority.

¹⁵ It is important that the audit committee be able to meet privately with the independent auditors, as needed, to ensure a full and candid discussion. Governments are urged to amend sunshine laws and similar open meetings legislation to permit such encounters in these limited circumstances.

¹⁶ It is important that audit committee members be able to meet privately among themselves, as needed, to ensure a full and candid discussion. Governments are urged to amend sunshine laws and similar open meetings legislation to permit such an encounter in these limited circumstances.



BEST PRACTICE

Establishing an Internal Audit Function

BACKGROUND:

The term "internal auditor" is commonly used in a variety of ways in the public sector. For example, some individuals with the title "internal auditor" are actually elected officials who, for all practical purposes, function as independent auditors. Conversely, many individuals in the public sector perform one or more of the duties of an internal auditor, although they may use some other job title. For purposes of this recommended practice, an "internal auditor" will be considered to be any audit professional who works directly for management, at some level, and whose primary responsibility is helping management to fulfill its duties as effectively and efficiently as possible.

Internal auditors can be of great value to state and local governments in a variety of ways. In particular, they commonly assist management in monitoring the design and proper functioning of internal control policies and procedures. In this capacity, internal auditors themselves function as an additional level of control and so help to improve the governments overall control environment. Internal auditors also can play a valuable role conducting performance audits, as well as special investigations and studies.

RECOMMENDATION:

GFOA makes the following recommendations regarding the internal audit function:

- Every government should consider the feasibility of establishing a formal internal audit function because such a function can play an important role in helping management to maintain a comprehensive framework of internal controls. As a rule, a formal internal audit function is particularly valuable for those activities involving a high degree of risk (e.g., complex accounting systems, contracts with outside parties, a rapidly changing environment). If it is not feasible to establish a separate internal audit function, a government is encouraged to consider either 1) assigning internal audit responsibilities to its regular employees or 2) obtaining the services of an accounting firm (other than the independent auditor) for this purpose;
- The internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means;
- It is recommended that internal auditors of state and local governments conduct their work in accordance with the professional standards relevant to internal auditing contained in the U.S. General Accounting Offices publication *Government Auditing Standards*, including those applicable to the independence of internal auditors;
- At a minimum, the head of the internal audit function should possess a college degree and appropriate relevant experience. It also is highly desirable that the head of the internal audit

function hold some appropriate form of professional certification (e.g., certified internal auditor, certified public accountant, certified information systems auditor); and

- All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the governments audit committee or its equivalent.

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American Institute of Certified Public Accountants (AICPA)

(Guidance)

10 Key Internal Audit Topics for Audit Committee Consideration

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Submitted to *Journal of Accountancy*

Introduction

One of an audit committee's most important responsibilities is to oversee the organization's internal audit function, which plays a major role in the areas of risk management and corporate governance. Typically, a Chief Audit Executive, or CAE, will have a direct reporting line to the audit committee, which has functional oversight of internal audit activities. To assist audit committees with this oversight, and to provide a strategic framework for the direction and orientation of internal audit, the authors outline 10 suggested topics for discussion between the CAE and the audit committee. These topics, framed as questions, stem from the results of the largest-ever global survey of internal auditors, which identified 10 "imperatives" for internal audit focus.

Every five years, the Institute of Internal Auditors (the "IIA") conducts its Global Internal Audit Survey to gain a current snapshot of the profession. The IIA's most recent survey included responses from more than 13,000 internal auditors around the world. During 2011, the Institute of Internal Auditors Research Foundation (IIARF) published a series of reports to discuss the results of the global survey. One report, *"The Global Internal Audit Survey, Imperatives for Change: The IIA's Global Internal Audit Survey in Action,"* used

the data as a springboard to take a forward look at the profession and suggest 10 areas for scrutiny and focus in the years ahead.

Although developed for internal auditors, the *Imperatives for Change* report also suggests a roadmap of important topics for joint consideration by the audit committee and chief audit executive. They also point to the linkages between topics and the need to consider the implications of their interrelationships.

10 Key Questions for Audit Committees

Outlined below are the 10 imperative topics for internal auditors recast into rhetorical questions for audit committees. Each question is followed by a short discussion of the topic, examples of related internal audit activities, and additional topics and/or questions for audit committee consideration.

Q1: What is the internal audit coverage of the organization's risk management and governance processes?

In recent years, internal auditors have been increasing their focus on the risk management and governance processes of the organizations they audit and assess. At the same time, audit committees have stepped up their interest in risk management and governance, reflecting the heightened oversight of these areas on the parts of regulatory and supervisory bodies in both the public and private sector. Given the



Guidance from the Board of Governors of the Federal Reserve System on the relationship between the risk assessment and the audit plan

“Risk assessments should be revised in light of changing market conditions, or laws and regulations and updated during the year as changes are identified in the business activities of the institution or observed in the markets in which the institution operates, but no less than annually. When the risk assessment indicates a change in risk, the audit plan should be reviewed to determine whether the planned audit coverage should be increased or decreased to address the revised assessment of risk.”

Supplemental Policy on the Internal Audit Function and It's Outsourcing, January 23, 2013

importance of these areas, the audit committee needs to evaluate the current and projected scope of internal audit coverage of risk management and governance .

In organizations in the initial stages of risk management implementation, the role of internal audit is often that of a catalyst or facilitator to help foster development of the organization's risk management processes. In such situations, internal auditors' knowledge of the organization and its risks can be very helpful. And as the organization's risk management processes mature, internal audit can serve in more of an assurance capacity, providing audit coverage of the risk practices that have been implemented.

On a similar note, internal audit also can provide advice and assurance over the organization's governance processes. Of note, the IIA's *International Standards for the Professional Practice of Internal Auditing* (the "Standards") now require internal auditors to address both risk management and governance processes in their audit coverage.

Q2: How responsive to change and flexible is internal audit's risk-based audit plan?

Internal auditors are required by the Standards to conduct a risk-based audit plan. While there is no one approach to conducting risk assessments and developing the related audit plan, many internal audit groups conduct an annual risk assessment and prepare an annual audit plan. In today's world of complex and dynamic risks, however, more and more internal audit groups are updating their risk assessments and audit plans on a more frequent and timely basis than just annually. For example, survey results indicate that it is becoming more common for internal auditors to update their audit plans on a quarterly basis. What's more, a number of internal audit groups have moved to "rolling" audit plans of that only cover six-month periods. By taking a more timely approach to their audit planning, organizations are helping to ensure that their audit coverage is focused at the most critical issues in a given time period.

The audit committee needs to understand how, and with what frequency, internal audit updates

their risk assessment and how responsive and flexible they are with their audit plans. In addition to recommended changes to the audit plan, the audit committee needs to ensure that internal audit provides it with a rundown on changes to the organization's risk profile or new emerging risks that are driving audit plan changes. By reviewing changes to the organization's risk profile, the audit committee can gain comfort that the recommended audit plan changes will address current risks.

One further point: The audit committee should have a clear understanding that the CAE's role extends beyond audit plan execution to ensure that the internal audit process is identifying changes to the organization's risks and addressing these risks on a timely basis.

Q3: How does internal audit use technology to enhance its auditing and monitoring activities?

Technology tools are increasingly being used by internal auditors to enhance both the efficiency and effectiveness of their auditing activities. For example, powerful data mining tools enable internal auditors to perform audit tests on entire populations of data as opposed to testing data samples alone. In addition, data mining tools enable internal auditors to monitor controls, risk and fraud indicators, and performance metrics. Given the scope of these capabilities, many internal auditors find that such tools offer significant opportunities to improve and enhance their auditing efforts.

Audit committees need to determine how their internal auditors are using technology, their plans for leveraging technology further, and what types of support the internal audit function needs to be successful. To make these determinations, the audit committee also needs to be aware of the specialized skills and budgetary support required by internal audit to achieve its technology objectives. These are all topics of possible inquiry by the audit committee.

Q4: What is the strategic vision and plan for internal audit?

With the rapid changes in commerce today, strategic planning has taken a new and elevated

focus in many organizations. Internal auditing is no different. For internal auditors to keep current with new developments in auditing, technology and business, they must plan effectively. As the IIA Global Survey indicates, “A well-conducted strategic planning exercise will allow the CAE to develop his or her mission and various approaches and strategies to achieving that mission.”

To assess the strategic orientation of their internal audit functions, audit committees should ask questions such as these:

- What is internal audit’s vision for the near- and mid-term future?
- Does internal audit have a strategic plan?
- How does internal audit plan to keep pace with the risks and processes in the business?
- Has internal audit identified gaps between where its processes and practices are today and where they need to be in the 3-5 years?
- Does the internal audit strategy align with and support the organization’s strategic plans?

The IIA’s Global Internal Audit Survey in Action - The need to develop strategies and actions to meet stakeholder expectations

To deal appropriately in a demanding operating environment, it is vital that the CAE, in concert with both the audit committee and senior management, achieve agreement on the specific areas of focus for the internal audit activity. It is also imperative for the CAE to determine the specific expectations of his or her chief stakeholders and to develop strategies and tactics to address these expectations. Moreover, it is critical to monitor stakeholder feedback in an ongoing, systematic manner and to update internal audit plans as needed to address changing expectations.

Q5: What perceived value does the organization receive from its internal audit activities?

According to the definition of internal auditing promulgated by the IIA, internal auditing activities are designed to “add value” to an organization. How an internal audit function goes about adding value differs from one organization to another, depending on the expectations of internal audit’s key stakeholders. Thus the challenge for audit committees and internal auditors alike is to define

clearly what those expectations for adding value are and then to tailor their processes to meet those expectations. .

For any internal audit function, providing assurance is a core and expected value driver. But what other types of value do stakeholders expect internal audit to provide? For example, some internal auditors today add value by providing high quality talent to their organizations. Others assist management by providing monitoring and data mining capabilities that contribute to improved business-unit performance, or assist in enhancing risk management and governance processes.

Irrespective of the specific value drivers of an organization, however, there should be clarity and agreement among internal audit, executive management and the audit committee as to stakeholder expectations and the specific internal audit activities to which stakeholders ascribe value. It’s then up to internal audit to address those expectations and value drivers and assess how well it is doing so. By operating in this manner, stakeholder perceptions become real and tangible and increase the likelihood that internal audit will deliver sought-after value.

Q6: How do we strengthen communications and relationships between internal audit and the audit committee?

Ideally, the relationship between internal audit and the audit committee will be characterized by open communications, respect and trust. To achieve and maintain such a relationship demands ongoing attention by both parties. For their part, members of the audit committee should continually ask themselves how they might enhance their relationship with internal audit, particularly with regard to informal communications.

One way to enhance audit committee/ CAE relationships is joint training involving the audit committee chair and chief audit executive. In another example of effective relationship building, a CAE’s direct reports meet periodically with the audit committee chair and are invited to make presentations to the audit committee. Such interactions



provide opportunities for the audit committee to see key members of the internal audit staff in action, a factor contributing to effective succession planning for the CAE.

Q7: How does internal audit ensure that its activities are in full compliance with “The International Standards for the Professional Practice of Internal Auditing?”

The IIA is the global standards-setting body for the internal audit profession. In this capacity, the IIA promulgates *The International Standards for the Professional Practice of Internal Auditing* (the “Standards”).

Most internal audit functions have charters stating that internal audit conducts its activities in accordance with these Standards. In the same manner that the audit committee expects its external auditors to comply fully with their professional standards, it should also expect its internal auditors to comply fully with their Standards. To this end, the audit committee should request periodic confirmation from their internal auditors that they do, indeed, comply fully with the IIA Standards.

Of note, the IIA Standards require an external assessment of the internal audit function at least every five years. The audit committee should ensure that this requirement is met and that it receives the report from the external reviewer.

Q8: How does internal audit acquire and develop top talent for the organization?

The quality of an organization’s internal audit function is heavily dependent on the quality of its people. This is especially true today where the amount of change and complexity of risks facing most organizations create significant and varying challenges. Traditional auditing and accounting skills remain highly valued in today’s environment, but must be augmented with non-traditional auditing skills. Data-mining specialists and staff with in-depth industry knowledge are just two types of talent being sought after by today’s internal audit functions.

A true measure of internal audit staff quality is the degree to which the internal audit function is perceived to be a source of talent for other

parts of the organization. Some companies have formal rotational programs wherein highly talented staff members are assigned to internal audit for a specific time period to gain valuable experience that can then be taken back to the business units. At other organizations, members of the internal audit staff are recruited by other organizational entities because of their in-depth knowledge of the business and its risks and controls. It is important for audit committees to be aware of the role that internal audit either *is* playing or *could be* playing to address the broader talent needs of the organization.

Q9: What types and levels of training necessary for internal audit to accomplish its mission?

For internal auditors to keep pace with the dynamic changes in business, technology and risk today, they must have access to continuous, current and robust training. An effective training program needs to go beyond basic accounting or auditing skills to address critical areas such as data mining and analysis, risk management, governance processes, new-product marketing and new technological applications. Softer skills – such as how to make good decisions, how to interview effectively, and how to think critically – also need to be stressed. In particular, the audit committee should inquire as to whether the training is adequately equipping the internal audit staff to conduct auditing activities appropriate for the organization’s current and evolving risk profile.

Q10. Does internal audit periodically inventory and assess its skills to identify gaps and, if so, how are they being addressed?

The dynamic nature of organization’s and their risks places a continuing demand on internal audit to periodically assess its skills inventory. In addition to audit and accounting capabilities, the organization’s risks may drive needs for specialists in languages, social media, data security, mathematics and beyond. In this environment, most internal audit functions will experience some sort of skills gap from time to time. When they do so, they are increasingly turning to third parties to supply needed skills on an “as needed” basis.



Audit committees need to have a critical discussion of skills with their internal audit leadership. In posing questions to the CAE and senior auditors, the audit committee should start with the internal audit risk assessment, not the audit plan. The central question: Has internal audit identified all the skills needed to address the organization's risk profile and where does it stand relative to acquiring those needed skills? The audit committee should encourage the CAE to consider various approaches to addressing those needs, including third parties as well as tapping corporate resources outside of internal audit to address particular needs.

The primary concern is that internal audit has the breadth of skills necessary to provide coverage and assurance over the organization's control and risk management processes. This is an issue that can be particularly critical to small- and medium-sized internal audit functions that lack the size or budget to have in-house access to the broad range of skills needed to address their changing risk profiles.

Conclusion

The 10 topics of discussion listed above can form a useful framework for in-depth discussions between an audit committee or audit committee chair and their chief audit executive. Such discussions can help both parties come to a better understanding and agreement on where their internal audit function stands relative to the profession and point to needed areas of

focus moving forward. Audit committees are encouraged to take advantage of the discussions above in seeking to gain additional insight on the quality and direction of the internal auditing activities being conducted under their oversight.

List the 10 questions

1. What is the internal audit coverage of the organization's risk management and governance processes?
2. How responsive to change and flexible is internal audit's risk-based audit plan?
3. How does internal audit use technology to enhance its auditing and monitoring activities?
4. What is the strategic vision and plan for internal audit?
5. What perceived value does the organization receive from its internal audit activities?
6. How do we strengthen communications and relationships between internal audit and the audit committee?
7. How does internal audit ensure that its activities are in full compliance with "The International Standards for the Professional Practice of Internal Auditing?"
8. How does internal audit acquire and develop top talent for the organization?
9. What types and levels of training are conducted by internal audit?
10. Does internal audit have skill or staffing gaps and, if so, how are they being addressed?

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MANAGEMENT OVERRIDE OF INTERNAL CONTROL:

**The Achilles' Heel of
Fraud Prevention**

**The Audit
Committee and
Oversight of
Financial Reporting**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



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2016 Update

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NOTICE TO READERS

Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention was originally published in 2005. This 2016 update makes relatively minor revisions to the original publication to align the earlier document with more recent technical guidance, pronouncements, and professional standards.

The purpose of this best practices document is to offer guidance to audit committees in addressing the risk of fraud through management override of internal control over financial reporting. By effectively overseeing management and addressing the risk of management override, audit committees increase the likelihood of preventing, deterring, and detecting fraudulent financial reporting. The guidance in this document is applicable, in various degrees, to audit committees of publicly traded companies; nonpublic companies; not-for-profit organizations; federal, state, and local government entities; and other entities.

This document is meant to help facilitate the audit committee's consideration of the risk of management override of internal control. If the reader would like to learn more about management antifraud programs and controls, please see the document titled *Fraud Risk Management Guide*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the Association of Certified Fraud Examiners (ACFE).

This document represents the views of the members of the AICPA's Antifraud Programs and Controls Task Force and has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. This document has no authoritative status. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate.

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The risks of fraud and management's ability to override internal control are present in every entity.

Section A: Management Override and the Audit Committee's Responsibilities

The chair of the audit committee of ControlCo was stunned. Company counsel had just advised him that the prior year's revenue and earnings may have been overstated. "But how could that happen? We have good internal control, and management and the auditors both signed off that they were effective!" he said. Ultimately, the chair learned of the "Achilles' heel" of any system of fraud prevention: Those who design and implement internal control—management—can also override or bypass those controls. The chair began to wonder, What might we have done differently? How can an audit committee prevent management from overriding internal control? A few weeks later, as the fraud became public, the chair felt even worse when reading the headline in the local newspaper: "Where Was the Audit Committee?"

Then, regulators and class action lawyers began to ask:

- Was the audit committee sufficiently involved, or were the members simply listeners? Did the audit committee's actions demonstrate an appropriate level of skepticism?*
- Did the individual members of the audit committee carefully read the quarterly financial statements? Did they understand the correct key performance indicators?*
- Was the audit committee alert to financial statement fraud risk factors? Did the audit committee members focus on the potential for manipulation of financial statements?*
- Were the entity's code of conduct and whistleblowing processes really important to the entity, or was it simply an effort to comply with regulatory requirements?*
- Was the audit committee making best use of the entity's internal auditors and independent auditors?*

Even though internal control over financial reporting (hereinafter referred to as *internal control* or simply as *controls*) may appear to be well-designed and effective, controls that are otherwise effective can be overridden by management in every entity. Many financial statement frauds have been perpetrated by intentional override by senior management of what might otherwise appear to be effective internal control. Indeed, with very few exceptions, most of the major fraud cases in the past 50 years that had catastrophic results for the organization were perpetrated by senior members of management circumventing or overriding seemingly sound systems of internal control. Audit committees may reduce the risk of material misstatement in the financial statements due to fraud by addressing the risk of management override of internal control as part of their oversight of the financial reporting process. This document provides guidance to audit committees in considering the risk of management override of internal control—the Achilles' heel of fraud prevention.

Because management is primarily responsible for the design, implementation, and maintenance of internal control, the entity is always exposed to the danger of management override of controls, whether the entity is publicly held, private, not-for-profit, or governmental. When the opportunity to override internal control is combined with powerful incentives to meet accounting objectives, senior management may engage in fraudulent financial reporting. Thus, otherwise

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effective internal control cannot be relied upon to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management.

Management may override controls to intentionally misstate the nature and timing of revenue or other transactions by (1) recording fictitious business events or transactions or changing the timing of recognition of legitimate transactions, particularly those recorded close to the end of an accounting period; (2) establishing or reversing reserves to manipulate results, including intentionally biasing assumptions and judgments used to estimate account balances; and (3) altering records and terms related to significant or unusual transactions.

The board¹ of directors and its audit committee are responsible for overseeing the actions of management. Corporate directors can no longer argue that they acted diligently in carrying out their responsibilities if they have failed to design a strong audit committee charter and timely perform all the functions specified therein. With respect to audit committee members, this includes the duty to inquire into the adequacy of their organization's internal control, both in theory and in practice, and to take actions, such as those described in this document, to minimize the possibility that internal control are overridden by management, thereby resulting in undetected fraud.

An appropriate tone at the top (set by the board of directors), implementation of a code of conduct or ethics, training programs, expanded auditing and public reporting on the effectiveness of internal control as required by the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act), and enhanced criminal penalties under the act all may be helpful fraud deterrents, but their mere existence will seldom provide assurance that management override can be prevented or timely detected.

The COSO *Internal Control—Integrated Framework* (2013) states that an “Internal control system is ... able to provide reasonable assurance—but not absolute assurance, to an entity’s senior management and board of directors.... While internal control provides reasonable assurance of achieving the entity’s objectives, limitations do exist.... Limitations may result from the ... ability of management to override internal control.”

A diligent audit committee will evaluate whether oversight mechanisms are in place and functioning that will prevent, deter, or detect management override of internal control. Furthermore, the U.S. Federal Sentencing Commission’s Federal Sentencing Guidelines (Federal Sentencing Guidelines) increase expectations for antifraud programs and controls and can serve as one useful tool in assessing the entity’s antifraud programs and controls.

The Federal Sentencing Guidelines) “offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical

¹ Throughout this publication, the terms *board* and *board of directors* refer to the governing or oversight body or those charged with governance of the organization.

conduct and in complying fully with all applicable laws.” [Footnote: 2014 Guidelines Manual, Chapter 8, Introductory Comments.]

The U.S. Federal Sentencing Commission first promulgated organizational sentencing guidelines in 1991. The sentencing guidelines apply to almost all types of organizations, including corporations, partnerships, unions, not-for-profit organizations, and trusts. One significant aspect of the sentencing guidelines is that each organization is responsible for the wrongful acts of its employees as long as the employees were acting in their official capacity—even if the organization did not know or approve of the employees' actions. The compliance program component has been a vital part of the sentencing guidelines since that time. Included in the sentencing guidelines are seven minimum requirements to be used to test the effectiveness of a compliance program. Those seven elements are as follows:

1. Establish policies, procedures, and controls
2. Exercise effective compliance and ethics oversight
3. Exercise due diligence to avoid delegation of authority to unethical individuals
4. Communicate and educate employees on compliance and ethics programs
5. Monitor and audit compliance and ethics programs for effectiveness
6. Ensure consistent enforcement and discipline of violations
7. Respond appropriately to incidents and take steps to prevent future incidents

Section B: Actions to Address the Risk of Management Override of Internal Control

Management override is very difficult to detect. However, an audit committee can take actions to address the risk of management override of controls. This section outlines several actions: maintaining an appropriate level of skepticism, strengthening committee understanding of the business, brainstorming about fraud risks, using the code of conduct to assess financial reporting culture, ensuring the entity cultivates a vigorous whistleblower program, and developing a broad information and feedback network.

Maintaining Skepticism

An effective starting point for the audit committee in assessing fraud risk is the exercise of an appropriate level of skepticism when considering the risk of management override of internal

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control. Skepticism is an attitude that acknowledges that fraud risks, including the risk of management override, exist in every entity. An appropriate level of audit committee skepticism requires alertness to potential fraud risk factors and a willingness to ask sometimes difficult and perhaps even embarrassing questions. It also requires an environment that encourages open and candid discussion among audit committee members and sufficient time to think and consider “what if” scenarios related to the possibilities of fraud at the entity. In considering the risk of management override of internal control, the audit committee will set aside any beliefs about the integrity of management because override is most often committed by “good executives gone bad,” rather than consistently dishonest people.

Appropriate skepticism by audit committee members is essential to their assessment of the risk of management override of internal control. With an appropriate attitude about the ever-present risk of management override, audit committee members can use their knowledge of the business and related financial statement risks to explicitly oversee the risk of management override of controls. Additionally, an open display of skepticism, in itself, can be a deterrent to management override of controls.

Strengthening Committee Understanding of the Business

Audit committees need a solid knowledge of the industry and business to form the foundation for effective oversight. Because financial reporting to stakeholders should reflect the economic activity of the entity, industry and entity knowledge is critical for determining whether the entity's financial reporting is sufficient for its users. That knowledge also helps the audit committee identify and understand business and financial risks that may increase the likelihood of fraud.

Most businesses plan legitimate reactions to variances from expected financial performance. Those reactions may include either new or additional transactions, or the cancellation, reduction, or postponement of transactions otherwise planned. For example, a business that is not meeting its earnings goals may accelerate or delay incurring expenses. It may decide on more or fewer new employees than planned, or it may change the pattern or timing of research and development or marketing efforts. An entity facing a profit shortfall may attempt to increase sales through a variety of means, including reducing prices, offering incentives, or expanding its sales force. Conversely, an entity surpassing its budgeted revenues may decide to slow sales by not filling orders for a short time to minimize overtime costs and balance customer inventory levels. These are usually legitimate, transaction-oriented means of “managing” operations.

When a business is unable to achieve desired results legitimately, the temptation to override internal control to manipulate reported results can ensue. The distinction between what is legitimate and not legitimate is not always clear, particularly when estimates are involved or when the accounting depends on a management decision. Understanding key earnings drivers and management's planned reactions to variations from expected performance increases the audit committee's ability to identify situations in which management's actions may have crossed the line and may no longer be legitimate. Audit committees will consider whether transactions make sense in the context of legitimate business purposes.

Management controls the key sources of revenue and earnings volatility through the management of the company's underlying business, operations, credit, and market risks. Management also is responsible for the numerous estimates and judgments underlying reported results. These sources include judgments on asset values, estimated liabilities, and contingencies, to name only a few. In some cases, nonfinancial data, such as subscribers or customers, or units sold, can be critical drivers of earnings and revenue. An audit committee that does not understand the key drivers of earnings and revenue and fails to focus on related

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key performance indicators may not be able to properly monitor management and may not have a reasonable chance of identifying fraud risk factors in advance of a crisis.

The identification of fraud-related incentives or pressures, opportunities, and attitudes or rationalizations begins with each audit committee member obtaining a solid and complete understanding of the business. This understanding can be used to assess fraud risk as the audit committee evaluates press releases, analysts' forecasts and reports, and financial reports to shareholders. Understanding the nature of the entity's core lines of business and management's compensation package may help the audit committee identify significant incentives or opportunities for fraud. Historically, technology, telecommunication, and service entities have been particularly vulnerable to these risks. In addition, certain industries or business operations are subject to accounting and financial reporting issues that are grounded in subjective determinations. These provide an opportunity for management to perpetrate a financial fraud.

Fraud-related incentives or pressures, opportunities, and attitudes or rationalizations constitute the "fraud triangle." According to auditing standards generally accepted in the United States of America (paragraph .A1 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* [AICPA, *Professional Standards*):

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act, as follows:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps, unrealistic) earnings target or financial outcome—particularly because the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets (for example, because the individuals are living beyond their means).
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden (for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control).
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A next step in identifying fraud risks involves the audit committee's understanding of what may threaten management's ability to accomplish its objectives and strategies. Those threats or risks include competition, capital constraints, major customer or vendor loss, production issues, economic downturn, or regulatory change. They too may create incentives or pressures for engaging in fraud.

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It is important for the audit committee to understand the financial reporting environment (for example, attitudes, ethics, motives, and pressures) affecting the CEO, CFO, and others who are involved in the entity's financial reporting. The internal reporting process between key segments of the business (across lines of business, divisions, and geographic segments) and senior management may also be important and worthy of audit committee inquiry. Unrealistic performance expectations, real or perceived, have too often been the catalyst for financial statement fraud at remote or relatively small business units. Information obtained by the audit committee about differences in the financial reporting cultures across different units may signal areas within the company where fraud risks may be heightened.

It is useful to understand the process of developing, reviewing, and revising budgets, as well as the company's budget "mentality." Because the operating budget can establish the earnings that the company hopes to report, it may prompt management to manage earnings when operations are not in line with expectations. For example, a budget that is intended as an incentive to divisions and subsidiaries to reach their highest potential can create pressures on managers to falsify reported results. An early challenge to an unrealistic budget by a well-informed audit committee can be an effective deterrent against management override of controls to reach unrealistic targets.

Finally, it is always important for the audit committee to have a thorough understanding of the incentives and pressures management personnel face due to the entity's incentive compensation programs. The ability to exercise stock options when the stock price reaches predetermined levels and financial performance-related bonuses can be strong motivators for positive change but can also place intense pressure on management to "manage" earnings improperly.

Brainstorming to Identify Fraud Risks

Members of the audit committee can increase their effectiveness in dealing with the potential of management override of internal control by discussing, among themselves, the potential for fraud. An exchange of ideas or "brainstorming" about how and where they believe the entity may be susceptible to fraud, what might motivate management to perpetrate fraud, how management might override controls to engage in and conceal fraudulent financial reporting, and how entity assets could be misappropriated can be useful for this purpose. The brainstorming session's effectiveness is increased if conducted, at least partially, in closed or executive session without management present.

The brainstorming session includes a consideration of known external and internal factors affecting the entity that might (1) create incentives or pressures for management and others to commit fraud, (2) provide the opportunity for fraud to be perpetrated, and (3) indicate a culture or environment that enables management to rationalize committing fraud. An attitude that includes a questioning mind, as described previously and, for this purpose, setting aside any prior positive beliefs regarding the honesty and integrity of management increases the usefulness of the discussion.

Audit committee discussions with internal auditors, independent auditors, counsel, the compensation committee, human resources, the compliance officer, marketing and sales, and business unit leadership may provide important input to the brainstorming session. Guidance as to the substance of those discussions is provided later in this document.

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Considering schemes used to perpetrate management fraud at other entities and the degrees to which such schemes might occur at this entity may also increase the effectiveness of the session. An antifraud specialist, working with the audit committee, can often enhance the effectiveness of the brainstorming session. The appendix to this document discusses fraud schemes and items the audit committee may consider when brainstorming to identify fraud risks.

Some initiatives that are especially important for having an effective brainstorming session include advance preparation by participants and efforts to ensure an open and frank discussion by all participants. A tendency in many brainstorming sessions is for the group to be overly influenced by initial ideas of a dominant personality. As such, the group will include ideas from all participants before determining which are most helpful. Once several fraud risks are identified, a prioritization by the combined likelihood of occurrence and the magnitude of impact can help focus the committee's efforts.

Possible brainstorming agenda items include the results of whistleblower hotline calls, fraud risk assessments performed by the company's independent auditors, fraud risk assessments performed as part of the entity's fraud risk management process, and other fraud risk factors or concerns identified by audit committee members.

Using the Code of Conduct to Assess Financial Reporting Culture

Most organizations have a code of conduct. The mere existence of a code, however, is not sufficient to reduce the likelihood of management override of controls.² The audit committee can use the code of conduct as a benchmark for assessing whether the culture or tone at the top and management's actions are those required to maintain the highest levels of integrity under pressure and opportunity to commit fraud. The code also facilitates the reporting of inappropriate conduct by delineating the types of conduct the organization deems unacceptable.

The audit committee will be routinely furnished with the results of any surveys of employees regarding corporate behavior and similar information received from external parties, such as customers and vendors. These can be excellent sources of information for the audit committee about the culture or tone at the top. Perceptions of management's commitment to uphold the code influence the degree to which employees and other parties follow the code and report violations of the code. The extent to which management is perceived to be committed to conduct sanctioned by the code will influence the audit committee's ability to deter, prevent, or detect management override of internal control. Equally important, an evaluation by the audit committee of how management communicates information about the code and motivates employees to comply with the code also provides information reflecting the culture or attitudes about ethical behavior within the organization. Employee awareness and training about the code may signal information about management's commitment to the code and indicate the likelihood that employees will report management code violations. Conversely, a lack of awareness by employees may signal management's lack of commitment to ethical conduct.

Cultivating a Vigorous Whistleblower Program

A key defense against management override of internal control is a whistleblowing process that typically incorporates either a telephone or web-based hotline, or a combination of both. The Association of Certified Fraud Examiners (ACFE) biennial fraud surveys consistently

² As a result of the Sarbanes-Oxley Act of 2002, Section 406, the SEC set rules requiring registrants to disclose whether the issuer has adopted a code of ethics for its senior executive officers and, if not, why.

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reveal that various forms of fraud are detected more than 40 percent of the time by tips from employees of the victim organization. Thus, this is the leading method for detecting fraud.³ Although the Sarbanes-Oxley Act⁴ requires that confidential reporting mechanisms be made available only to employees, opening the system to suppliers, customers, and others can increase the number of reports by approximately 50 percent.⁵

The audit committee can assist in creating strong antifraud controls by encouraging the development of a culture in which employees view whistleblowing as a valuable contribution to an attractive workplace of integrity and their own futures. The reporting mechanisms must demonstrate confidentiality so potential whistleblowers are assured that their concerns will be properly considered and that they will not be subjected to retribution. Successful whistleblowing procedures require strong leadership from the audit committee, the board of directors, and management.

For the audit committee to effectively monitor the risk of management override of internal control, the automatic and direct submission to the audit committee of all complaints involving senior management (without filtering by management or other entity personnel) is essential. The audit committee's primary interest is complaints related to accounting, internal control, and auditing.

By engaging internal auditors to periodically evaluate the design and operating effectiveness of the hotline, the audit committee can ensure that the hotline reflects changes in the company's operations and in best practices and indicate satisfactory support from management, employees, and other participants. Tests and evaluations by internal auditors of whether protocols established for forwarding information to the audit committee have been followed are important.

Developing a Broad Information and Feedback Network

Identifying situations when management has overridden internal control is difficult because those actions are not obvious and are not expected of a trusted management team. To respond to that challenge, the development of an extensive information network that extends beyond senior management may significantly increase the audit committee's ability to detect management override of internal control. In addition to the financial reporting process, the network often includes the following:

- Internal auditors
- Independent auditors
- Compensation committee
- Key employees

The audit committee may consider meeting periodically with representatives from each of the above groups to discuss matters affecting the financial reporting process, including significant

³ See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE), www.acfe.net.

⁴ A whistleblowing hotline is the *statutory responsibility of the audit committee* and cannot simply be delegated to entity officials. Section 301 of the Sarbanes-Oxley Act of 2002 requires that audit committees establish effective "whistleblowing" procedures.

⁵ See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE), www.acfe.net.

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estimates, fraud risks, key internal controls, and any other items of concern. Inconsistencies in information obtained from these sources may signal that management override of internal control is present. The information obtained from these sources may be useful to the audit committee in its brainstorming session about the risk of management override of internal control.

Communications With Internal Auditors

First and foremost, the internal audit department will understand that its responsibilities are primarily to the audit committee. A strong internal audit function may also include audit committee oversight of the internal audit group's budget approval process and its policies regarding hiring, evaluation, training, and termination of internal audit staff. Terminating or transferring high level internal audit personnel will be ultimately determined by the audit committee.

Executive sessions with the head of the internal audit function at every audit committee meeting provide the audit committee a unique opportunity to engage in candid discussions with him or her about the possible risk of management override of internal control and any indications of improper conduct by senior management.

The audit committee, by understanding and assisting in developing the internal auditors' annual audit plan, will influence the internal auditors' agenda by directing the plan's emphasis to areas of particular interest to the audit committee. These areas might include fraud risks—particularly matters that surfaced during the brainstorming session—and controls over judgments and estimates and key information processes. A properly directed internal audit staff can serve as the “eyes and ears” of the audit committee.

Specific inquiries might include the following:

1. What fraud risks are being monitored by the internal audit team on a periodic or regular basis? How does internal audit address the continuous auditing of these critical risks, in particular, with respect to the use of data analytics?
2. What specific procedures does internal audit perform to address management override of internal control?
3. Has anything occurred that would lead internal audit to change its assessment of the risk of management override of internal control?

Communications With Independent Auditors

The Sarbanes-Oxley Act requires that the independent auditors be appointed by the audit committee. As a best practice, all audit committees—even those not subject to the Sarbanes-Oxley Act—may consider being responsible for the appointment of the independent auditors. In this way, the audit committee can ensure that the independent auditors report directly to the committee. A strong and candid relationship, including an open dialogue between the independent auditors and the audit committee, can provide a useful foundation for the audit committee's assessment of fraud risk, including the risk of management override of internal control.

Specific inquiries might include the following:

1. What fraud risks are independent auditors addressing through audit procedures, in particular, risks related to management override of internal control?

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

2. What other matters were discussed in the audit team brainstorming session on fraud risk?
3. What were the results of the independent auditors' inquiries of management about fraud? Did those inquiries result in the identification of specific processes, transactions, or people that were the subject of concerns regarding higher fraud risk?
4. What are the results of audit procedures designed to address the risk of management override of internal control?

Additionally, the audit committee will be aware that the independent auditors are required to address the risk of management override of controls apart from any conclusions regarding the existence of other risks.⁶ The audit committee members will recognize that the independent auditors have given extensive consideration to the risk of financial statement fraud and use the work performed by the independent auditors to the greatest extent possible.

Paragraph .15 of AU-C section 240 states that AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), requires a discussion among the key engagement team members, including the engagement partner, and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. Paragraph .15 of AU-C section 240 also requires that this discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

Communications With the Compensation Committee

The compensation committee of the board approves programs for executive compensation and broad-based incentive plans. The audit committee's understanding of these plans is important when the plans may result in a heightened risk of fraudulent financial reporting primarily through creating excessive incentives or pressures to meet the plans' targets.

In addition to reviewing the minutes of compensation committee meetings, it is important for the audit committee to understand the performance incentives and possible unintended consequences that could lead to fraudulent financial reporting. For example, if company-wide earnings-per-share is a major factor affecting compensation, or if stock or option awards are a significant element of compensation, management's integrity can be put under stress if the company has difficulty meeting earnings targets. Additionally, when the compensation committee evaluates management's performance, best practices might include the compensation committee seeking the audit committee's assessment of the entity's internal control environment, including the tone at the top.

Communications With Key Employees

⁶ See paragraph .32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

The development of an information network with other key entity employees can be very beneficial. Focal points to consider include the general counsel, compliance or security director, human resources department, marketing or sales department, and business unit leaders.

The entity's general counsel may be aware of potential violations of laws and regulations, violations of the entity's code of conduct, or pressures that management may be experiencing. Typically, the audit committee's inquiry of the general counsel about any known pressures to structure significant or unusual transactions designed to achieve financial targets may signal the possibilities of fraud. Additionally, the general counsel generally would be asked about major legal risks that the entity may be facing, which may create significant pressures to engage in fraud. Specific questions to the general counsel can be structured by the audit committee based on the environment and can be focused, as appropriate, on issues potentially affecting management integrity. Additionally, as a best practice, the audit committee may consider having a dialogue with the entity's external counsel. If such a dialogue is established, the audit committee may ask about any inquiries that management may have made to the external counsel.

The human resources department may also play a key role in the audit committee's information network. Pre-employment screening, monitoring, and employee discipline are all part of the entity's antifraud program. The exit interview process and resignation letters with respect to employees in the accounting and finance function, employee surveys, and whistleblower hotline reports about human resources issues may be valuable sources of information regarding management integrity and the tone at the top.

The audit committee will want to establish an open and comfortable reporting relationship with the entity employee who has responsibility for compliance with laws and regulations and physical security. Frequent violations of laws or regulations may indicate a cavalier attitude by management regarding rules and an increased risk of management override of internal control.

Revenue recognition is almost always a fraud risk. Periodic conversations with the appropriate marketing and sales personnel about company policies and controls over selling activities may reveal pressures to meet revenue targets and possible inappropriate behavior. Marketing personnel may not fully appreciate the accounting significance of certain types of contract provisions—formal or informal. Interaction with the audit committee can help send an important message and further strengthen a tone at the top across the broader organization. Additionally, sales-related activities have been the focal point of numerous financial statement frauds relating to distorted revenue or sales transactions. This type of risk is higher in certain industries and often can simply involve aggressive marketing rather than fraud. Nonetheless, the misstatement of the financial statements can be significant. Therefore, the audit committee may often find it beneficial to meet with appropriate marketing and sales personnel to determine whether any revenue recognition issues exist and how management override could result in fraudulent revenue recognition.

Leaders of business units within an enterprise may face significant incentives or pressures imposed by senior management to meet internal targets or other performance metrics. When business unit leaders perceive these incentives or pressures to be extreme, they may be motivated to engage in activities that may include the override of internal control to fraudulently report financial results related to business unit operations. Business unit leaders may also be aware of senior management activities to override internal control performed at the business unit level for purposes of fraudulently reporting financial results at the consolidated level.

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

Dialogue with business unit leaders about performance-based incentives and management-imposed pressures may provide the audit committee with effective information about the risk of potential management override of internal control to fraudulently distort financial performance. For example, periodic inquiry of key business unit leaders about their perceptions of senior management pressure to meet performance targets and whether business unit leaders have been asked by senior management to engage in questionable activities to meet those targets may provide insightful information to the audit committee about the potential presence of management override of internal control.

Additionally, the layer of management below senior management may be the most likely to be aware of management override and, therefore, establishing an open line of communication with members of management one or two levels below senior management is important.

To identify information about potential financial statement fraud, the audit committee will need to establish a confidential dialogue with key employees. For example, an audit committee member who avails himself or herself of an opportunity to interact with key employees during company meetings or functions may get a sense of employee attitudes toward the company. The audit committee member may also learn about the tone at the top, employee knowledge of antifraud programs and controls, including the whistleblower program, and other information that employees may be reluctant to communicate through the whistleblower program. Whenever audit committee members are “out and about,” it may be beneficial to take advantage of the opportunity to talk to entity leaders. The important, and sometimes difficult, task is to do so without damaging relations with management by sending a strong message of mistrust.

Conclusion

The risk of management override of internal control is present in every entity. Although the best practices guidance provided in this document cannot guarantee that the audit committee will prevent, deter, or detect fraud through management override of internal control, the implementation of these suggestions will result in more effective audit committee oversight of management. Perhaps most importantly, this guidance may prevent the nightmare scenario of ControlCo (see page 1) and the subsequent question, “Where was the audit committee?”

**Appendix:
Suggested Audit Committee Procedures:
Strengthening Knowledge of the Business and
Related Financial Statement Risks**

As an audit committee addresses fraud risk in general and risk of management override in particular, it is useful to consider frequently occurring fraud schemes and ask, "Can they happen here?" Evidence from fraud-related research may be helpful in this regard.¹

Research has found that the most frequent type of fraud is asset misappropriation (about 80 percent to 85 percent of reported cases). Financial statement frauds (usually perpetrated by senior members of management) account for about 8 percent to 10 percent of reported cases. Although financial statement or managerial frauds are less frequent, such frauds can have catastrophic results. The median loss caused by asset misappropriation is about \$120,000 to \$130,000. The median loss caused by financial statement fraud is about \$1 million.

Frauds perpetrated by owners and executives account for only about 19 percent of reported cases (whereas frauds perpetrated by employees account for about 41 percent of reported cases). But, the median loss due to owner and executive frauds was more than \$700,000 (whereas the median loss due to employee frauds was about \$65,000).

Discovered frauds perpetrated by employees took a median of 12 months to detect. Discovered frauds perpetrated by owners and executives, however, took a median of 24 months to detect.

Although management is primarily responsible for designing, implementing, and maintaining controls for preventing employee fraud, management cannot be relied upon for preventing financial statement or management fraud. That is a key responsibility of the audit committee.

As the audit committee evaluates the entity and entity management, it can be helpful to ponder the questions in this appendix related to the three elements of the "fraud triangle:" incentives or pressures, opportunities, and attitudes or rationalizations. These queries can be particularly helpful in structuring an effective brainstorming session. Answers to these questions can also provide focus for planning additional steps designed to control the risk of management override of internal control. Some of these additional steps can be undertaken by the audit committee. Other follow-up assessment steps can be delegated to internal or external auditors. A positive answer to any of the following questions does not necessarily imply that fraud has occurred. Rather, a positive answer indicates that a heightened risk of fraud may exist, and further evaluation by the audit committee may be prudent.

¹ These statistics are based on research conducted by the Association of Certified Fraud Examiners. See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE). www.acfe.net.

Incentives or Pressures on Management

1. Is the entity's financial stability or profitability threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following?
 - High degree of competition or market saturation, accompanied by declining margins
 - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
 - Significant declines in customer demand and increasing business failures in either the industry or overall economy
 - Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
 - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
 - Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
 - New accounting, statutory, or regulatory requirements
2. Does excessive pressure exist for management to meet the requirements or expectations of third parties due to the following?
 - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
 - Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures
 - Marginal ability to meet debt repayment or other debt covenant requirements
 - Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
3. Is management's personal financial situation threatened by the entity's financial performance arising from the following?
 - Significant financial interests in the entity
 - Significant portions of compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow (Note: Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.)
 - Personal guarantees of debts of the entity
4. Is there excessive pressure on management or operating personnel to meet financial targets set by the board of directors or management, including sales or profitability incentive goals, budgets, or publicized forecasts or projections?

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

5. Are earnings expected to be “managed” at the subsidiary or division level, creating pressures on lower-level managers to meet higher-level management expectations?
6. Is there a perception of adverse consequences on lower-level managers if subsidiaries or divisions fail to exceed or fall short of budgeted, projected, or forecasted results?

Opportunities Management Can Exploit

1. Does the nature of the industry or the entity's operations provide opportunities to engage in fraudulent financial reporting that can arise from the following?
 - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
 - A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
 - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
 - Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions
 - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
 - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
 - Significant accounting system changes, particularly the implementation of new, complex systems or where control effectiveness was not adequately considered
 - Major structural changes, such as acquisitions or spin-offs, that might have affected internal control creating the likelihood of financial statement error
2. Are significant estimates used in the annual or quarterly financial reporting process unrealistic or inconsistent with actual historical results or with the performance of other entities in the same industry?
3. Is there ineffective monitoring of management as a result of the following?
 - Domination of management by a single person or small group (in a non-owner managed business) without compensating internal control
 - Ineffective oversight over the financial reporting process and internal control
4. Is there a complex or unstable organizational structure as evidenced by the following?
 - Difficulty in determining the organization or individuals that have controlling interest in the entity
 - Overly complex organizational structure involving unusual legal entities or managerial lines of authority
 - High turnover of senior management, counsel, or board members
5. Are internal control components deficient as a result of the following?
 - Inadequate monitoring of internal control, including automated controls and controls over interim financial reporting (where external reporting is required)?

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
 - Ineffective accounting and information systems, including situations involving reportable conditions
6. Are there indications that the qualifications and capabilities of the finance or accounting organizations and key personnel need significant improvement?

Attitudes or Rationalizations Exhibited by Management

1. Is there any evidence of ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards?
2. Is there any evidence of nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates?
3. Is there a known history of violations of securities laws or other laws and regulations, or claims against the entity or its senior management, alleging fraud or violations of laws and regulations?
4. Is there excessive interest by management in maintaining or increasing the entity's stock price or earnings trend?
5. Is there a practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts?
6. Has management failed to correct known reportable conditions on a timely basis in the past or during the current year's audit?
7. Has management exhibited an interest in employing inappropriate means to minimize reported earnings for tax-motivated reasons?
8. Have there been attempts by management to justify marginal or inappropriate accounting on the basis of materiality?
9. Is the relationship between management and the current or predecessor auditor strained, as exhibited by the following?
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
 - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
 - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement
10. Has management failed to identify business risks on a timely basis or failed to adequately monitor identified risks?
11. Has management been unwilling to address, on a timely basis, issues that could result in significant financial statement adjustments or adverse disclosures?

Management Override of Internal Control: The Achilles' Heel of Fraud Prevention

12. Have management, internal auditors, or the independent auditors exhibited a less-than-diligent attitude regarding the entity's antifraud programs and controls?
13. Are disclosures and other information in Management's Discussion and Analysis of Financial Condition and Results of Operations overly optimistic or inconsistent with the audit committee's knowledge of operations, the industry, or the entity's performance?

Association of Certified Fraud Examiners (ACFE)

(Executive Summary and 2016 Report to the Nations on
Occupational Fraud and Abuse)

Executive Summary

- The CFEs who participated in our survey estimated that the typical organization loses 5% of revenues in a given year as a result of fraud.
- The total loss caused by the cases in our study exceeded \$6.3 billion, with an average loss per case of \$2.7 million.
- The median loss for all cases in our study was \$150,000, with 23.2% of cases causing losses of \$1 million or more.
- Asset misappropriation was by far the most common form of occupational fraud, occurring in more than 83% of cases, but causing the smallest median loss of \$125,000. Financial statement fraud was on the other end of the spectrum, occurring in less than 10% of cases but causing a median loss of \$975,000. Corruption cases fell in the middle, with 35.4% of cases and a median loss of \$200,000.
- Among the various forms of asset misappropriation, billing schemes and check tampering schemes posed the greatest risk based on their relative frequency and median loss.
- The longer a fraud lasted, the greater the financial damage it caused. While the median duration of the frauds in our study was 18 months, the losses rose as the duration increased. At the extreme end, schemes that lasted more than five years caused a median loss of \$850,000.
- In 94.5% of the cases in our study, the perpetrator took some efforts to conceal the fraud. The most common concealment methods were creating and altering physical documents.
- The most common detection method in our study was tips (39.1% of cases), but organizations that had reporting hotlines were much more likely to detect fraud through tips than organizations without hotlines (47.3% compared to 28.2%, respectively).
- When fraud was uncovered through active detection methods, such as surveillance and monitoring or account reconciliation, the median loss and median duration of the schemes were lower than when the schemes were detected through passive methods, such as notification by police or by accidental discovery.
- In cases detected by tip at organizations with formal fraud reporting mechanisms, telephone hotlines were the most commonly used method (39.5%). However, tips submitted via email (34.1%) and web-based or online form (23.5%) combined to make reporting more common through the Internet than by telephone.
- Whistleblowers were most likely to report fraud to their direct supervisors (20.6% of cases) or company executives (18%).
- Approximately two-thirds of the cases reported to us targeted privately held or publicly owned companies. These for-profit organizations suffered the largest median losses among the types of organizations analyzed, at \$180,000 and \$178,000, respectively.
- Of the cases involving a government victim, those that occurred at the federal level reported the highest median loss (\$194,000), compared to state or provincial (\$100,000) and local entities (\$80,000).
- The median loss suffered by small organizations (those with fewer than 100 employees) was the same as that incurred by the largest organizations (those with more than 10,000 employees). However, this type of loss is likely to have a much greater impact on smaller organizations.
- Organizations of different sizes tend to have different fraud risks. Corruption was more prevalent in larger organizations, while check tampering, skimming, payroll, and cash larceny schemes were twice as common in small organizations as in larger organizations.

\$6.3
BILLION
IN TOTAL LOSSES



\$150,000
MEDIAN LOSS PER CASE

- The banking and financial services, government and public administration, and manufacturing industries were the most represented sectors in the fraud cases we examined.
- Although mining and wholesale trade had the fewest cases of any industry in our study, those industries reported the greatest median losses of \$500,000 and \$450,000, respectively.
- As in previous studies, external audits of the financial statements were the most commonly implemented anti-fraud control; nearly 82% of the organizations in our study underwent independent audits. Similarly, 81.1% of organizations had a code of conduct in place at the time the fraud occurred.
- Small organizations had a significantly lower implementation rate of anti-fraud controls than large organizations. This gap in fraud prevention and detection coverage leaves small organizations extremely susceptible to frauds that can cause significant damage to their limited resources.
- While the implementation rates of anti-fraud controls varied by geographical region, several controls—external audits of the financial statements, code of conduct, and management certification of the financial statements—were consistently among the most commonly implemented across organizations in all locations.
- The presence of anti-fraud controls was correlated with both lower fraud losses and quicker detection. We compared organizations that had specific anti-fraud controls in place against organizations lacking those controls and found that where controls were present, fraud losses were 14.3%–54% lower and frauds were detected 33.3%–50% more quickly.
- The most prominent organizational weakness that contributed to the frauds in our study was a lack of internal controls, which was cited in 29.3% of cases, followed by an override of existing internal controls, which contributed to just over 20% of cases.
- The perpetrator’s level of authority was strongly correlated with the size of the fraud. The median loss in a scheme committed by an owner/executive was \$703,000. This was more than four times higher than the median loss caused by managers (\$173,000) and nearly 11 times higher than the loss caused by employees (\$65,000).
- More occupational frauds originated in the accounting department (16.6%) than in any other business unit. Of the frauds we analyzed, more than three-fourths were committed by individuals working in seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing, and finance.
- The more individuals involved in an occupational fraud scheme, the higher losses tended to be. The median loss caused by a single perpetrator was \$85,000. When two people conspired, the median loss was \$150,000; three conspirators caused \$220,000 in losses; four caused \$294,000; and for schemes with five or more perpetrators, the median loss was \$633,000.
- Fraud perpetrators tended to display behavioral warning signs when they were engaged in their crimes. The most common red flags were living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general “wheeler-dealer” attitude involving unscrupulous behavior, and recent divorce or family problems. At least one of these red flags was exhibited during the fraud in 78.9% of cases.
- Most occupational fraudsters are first-time offenders. Only 5.2% of perpetrators in this study had previously been convicted of a fraud-related offense, and only 8.3% had previously been fired by an employer for fraud-related conduct.
- In 40.7% of cases, the victim organizations decided not to refer their fraud cases to law enforcement, with fear of bad publicity being the most-cited reason.
- Of the cases in our study, 23.1% resulted in a civil suit, and 80.8% of such completed suits led to either a judgment for the victim or a settlement.
- In our study, 8.4% of the victim organizations were fined as a result of the fraud. The proportion of victim organizations fined was highest in the Western Europe (15.6%), Southern Asia (13.6%), and Asia-Pacific (11.7%) regions.

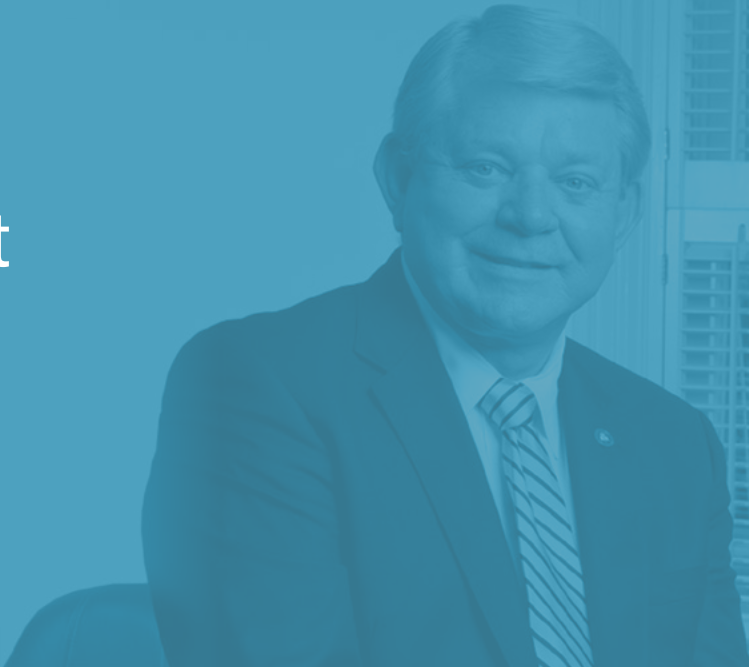
REPORT TO THE NATIONS

ON OCCUPATIONAL FRAUD AND ABUSE

2016 GLOBAL FRAUD STUDY



Letter from the President



In 1996, Dr. Joseph T. Wells, CFE, CPA, founder and Chairman of the ACFE, directed the publication of the first *Report to the Nation on Occupational Fraud and Abuse*. That study was a truly groundbreaking effort. Analyzing actual case information provided by Certified Fraud Examiners, the report presented statistical data on the cost of occupational fraud, the perpetrators, the victims, and the various methods used to commit these crimes. This was the first study of its kind, and the findings in the 1996 report serve as the foundation for much of what we now know about how occupational fraud and abuse affects organizations.

It might be hard for some readers to understand or recall just how little we knew about occupational fraud twenty years ago, but until the release of the first report, there was virtually no statistical information available on the cost, frequency, methodology, or any other aspect of occupational fraud. Those who worked in the fraud examination field knew the problem was huge, but no one could say precisely how large, and this made it very difficult to explain to organizations and clients what a tremendous threat they faced.

If there is one great contribution the *Report to the Nations* has made to the anti-fraud community, it has been in helping to raise the general level of awareness about fraud risk. We now live in a world where virtually all business and government organizations understand that fraud is a threat they must deal with. That was most certainly not the case in 1996. The challenge of preventing and detecting these crimes is still formidable, but recognizing the threat is the first step, and we are honored to know that information contained in the past eight editions of the report has been used by anti-fraud professionals throughout the world to educate their employers and clients.

On behalf of the ACFE, I am proud to present the 2016 edition of the *Report to the Nations*, our ninth and most extensive study to date. I believe the information contained in this report will be of great value to anti-fraud practitioners, business leaders, government officials, academics, the media, and anyone else with an interest in understanding the tremendous economic threat posed by occupational fraud.

James D. Ratley, CFE

A handwritten signature in black ink that reads "James D. Ratley". The signature is written in a cursive, flowing style.

President

Association of Certified Fraud Examiners

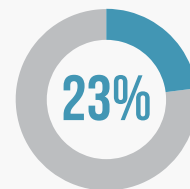
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\$6.3
BILLION
IN TOTAL LOSSES



OF CASES CAUSED LOSSES OF
\$1 MILLION OR MORE



\$150,000
MEDIAN LOSS PER CASE

- The banking and financial services, government and public administration, and manufacturing industries were the most represented sectors in the fraud cases we examined.
- Although mining and wholesale trade had the fewest cases of any industry in our study, those industries reported the greatest median losses of \$500,000 and \$450,000, respectively.
- As in previous studies, external audits of the financial statements were the most commonly implemented anti-fraud control; nearly 82% of the organizations in our study underwent independent audits. Similarly, 81.1% of organizations had a code of conduct in place at the time the fraud occurred.
- Small organizations had a significantly lower implementation rate of anti-fraud controls than large organizations. This gap in fraud prevention and detection coverage leaves small organizations extremely susceptible to frauds that can cause significant damage to their limited resources.
- While the implementation rates of anti-fraud controls varied by geographical region, several controls—external audits of the financial statements, code of conduct, and management certification of the financial statements—were consistently among the most commonly implemented across organizations in all locations.
- The presence of anti-fraud controls was correlated with both lower fraud losses and quicker detection. We compared organizations that had specific anti-fraud controls in place against organizations lacking those controls and found that where controls were present, fraud losses were 14.3%–54% lower and frauds were detected 33.3%–50% more quickly.
- The most prominent organizational weakness that contributed to the frauds in our study was a lack of internal controls, which was cited in 29.3% of cases, followed by an override of existing internal controls, which contributed to just over 20% of cases.
- The perpetrator’s level of authority was strongly correlated with the size of the fraud. The median loss in a scheme committed by an owner/executive was \$703,000. This was more than four times higher than the median loss caused by managers (\$173,000) and nearly 11 times higher than the loss caused by employees (\$65,000).
- More occupational frauds originated in the accounting department (16.6%) than in any other business unit. Of the frauds we analyzed, more than three-fourths were committed by individuals working in seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing, and finance.
- The more individuals involved in an occupational fraud scheme, the higher losses tended to be. The median loss caused by a single perpetrator was \$85,000. When two people conspired, the median loss was \$150,000; three conspirators caused \$220,000 in losses; four caused \$294,000; and for schemes with five or more perpetrators, the median loss was \$633,000.
- Fraud perpetrators tended to display behavioral warning signs when they were engaged in their crimes. The most common red flags were living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general “wheeler-dealer” attitude involving unscrupulous behavior, and recent divorce or family problems. At least one of these red flags was exhibited during the fraud in 78.9% of cases.
- Most occupational fraudsters are first-time offenders. Only 5.2% of perpetrators in this study had previously been convicted of a fraud-related offense, and only 8.3% had previously been fired by an employer for fraud-related conduct.
- In 40.7% of cases, the victim organizations decided not to refer their fraud cases to law enforcement, with fear of bad publicity being the most-cited reason.
- Of the cases in our study, 23.1% resulted in a civil suit, and 80.8% of such completed suits led to either a judgment for the victim or a settlement.
- In our study, 8.4% of the victim organizations were fined as a result of the fraud. The proportion of victim organizations fined was highest in the Western Europe (15.6%), Southern Asia (13.6%), and Asia-Pacific (11.7%) regions.

Introduction



Organizations face numerous risks to their success; economic risk, disaster risk, supply-chain risk, regulatory risk, and technology risk all affect organizations in different ways and to varying degrees. While fraud risk is just one of the many entries on this list, it is universally faced by all business and government entities. Any organization with assets is in danger of those resources being targeted by dishonest individuals. And, unfortunately, a notable portion of that threat comes from the very people who have been hired to carry out the organization's operations. It is this risk—the risk of occupational fraud¹—that the first *Report to the Nation on Occupational Fraud and Abuse* was published in 1996 to explore.

In the twenty years since the inaugural report was released, our continuing research on these topics has not only come to represent the largest collection of occupational fraud cases ever analyzed, but has also illuminated

several notable trends in how such fraud is committed, how it is detected, and how organizations combat this threat. The stated goals of the 2016 report are the same as those of its predecessors:

- To summarize the opinions of experts on the percentage of organizational revenue lost to fraud each year
- To categorize the ways in which occupational fraud occurs
- To analyze the characteristics of the individuals who commit occupational fraud
- To examine the characteristics of the organizations that are victimized by occupational fraud

This report contains an analysis of 2,410 cases of occupational fraud that were investigated between January 2014 and October 2015. Figure 1 provides a summary

¹ *Occupational fraud* can be defined as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."

of where these cases occurred,² as well as the relative losses incurred by the victims in different geographical regions. Readers should note that the number of cases in each region largely reflects the demographics of ACFE membership, as that is the source of our data. Thus, this figure should not be interpreted to mean that occupational fraud is necessarily more or less likely to occur in any particular region.

Figure 1: Geographical Location of Victim Organizations

Region	Number of Cases	Percent of Cases	Median Loss (in U.S. dollars)
United States	1038	48.8%	\$120,000
Sub-Saharan Africa	285	13.4%	\$143,000
Asia-Pacific	221	10.4%	\$245,000
Latin America and the Caribbean	112	5.3%	\$174,000
Western Europe	110	5.2%	\$263,000
Eastern Europe and Western/Central Asia	98	4.6%	\$200,000
Southern Asia	98	4.6%	\$100,000
Canada	86	4.0%	\$154,000
Middle East and North Africa	79	3.7%	\$275,000

The findings presented in this report continue the ACFE's mission of educating anti-fraud professionals, organizational leaders, and the public at large about the threat of occupational fraud and how to effectively prevent and detect it. The 2016 report shows the continuation of numerous trends that we have identified during previous studies, provides information in several new areas, and highlights interesting ways that the occurrence of fraud has evolved over time and varies across regions. We hope readers come away with a clear picture of how occupational fraud is perpetrated and how it affects its victims, as well as the importance of proactive initiatives to combat this risk.

² Geographical location was provided for 2,127 of the cases submitted; see the Appendix on page 84 for a detailed breakdown of these cases by country.



THIS REPORT CONTAINS AN ANALYSIS OF 2,410 CASES
OF OCCUPATIONAL FRAUD THAT WERE INVESTIGATED
BETWEEN JANUARY 2014 AND OCTOBER 2015. THE
FRAUDS IN THIS STUDY TOOK PLACE IN **114 DIFFERENT**
COUNTRIES THROUGHOUT THE WORLD.

The Cost of Occupational Fraud



Anti-fraud professionals, business managers, government and regulatory agencies, and the media each have a vested interest in assessing the total amount of money lost to fraud each year. While many studies have attempted to determine the extent of fraud's financial impact, the challenges in arriving at the true total cost of fraud are numerous. It is impossible to know exactly how much fraud goes undetected or unreported, and even calculations based solely on known fraud cases are likely to be underestimated, as many victims downplay or miscalculate the amount of damage. Nonetheless, attempts to determine the cost of fraud are important, because understanding the size of the problem brings attention to its impact, enables organizations to quantify their fraud risk, and helps management make educated decisions about investing in anti-fraud resources and programs.

Projecting Total Fraud Losses Based on Imperfect Data

To help measure the financial damage caused by fraud, we asked the CFEs who participated in our study to provide us with their best estimate, based on their experience, of what percentage of revenues the typical organization loses in a given year as a result of fraud. The median estimate was that fraud costs organizations 5%

of revenues each year. As one way to illustrate the magnitude of this estimate, applying this percentage to the 2014 estimated Gross World Product of \$74.16 trillion results in a projected potential total fraud loss of up to \$3.7 trillion worldwide.³ The limitation of this type of estimate is that it is based solely on the opinions of our survey participants and not on any specific data about actual fraud losses. However, the estimate comes from the collective knowledge of thousands of CFEs who together have tens of thousands of years' experience in the anti-fraud field. Given the impossibility of obtaining loss data on all frauds, including those that are undetected or unreported, this group likely has as much understanding about the harm fraud causes as any other resource available.⁴

The Fraud Costs We Know

But the primary purpose of this study is not to make estimates; our goal is to collect and report actual case data. In terms of hard numbers, the total loss caused by the

³ <https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html> (retrieved March 4, 2016)

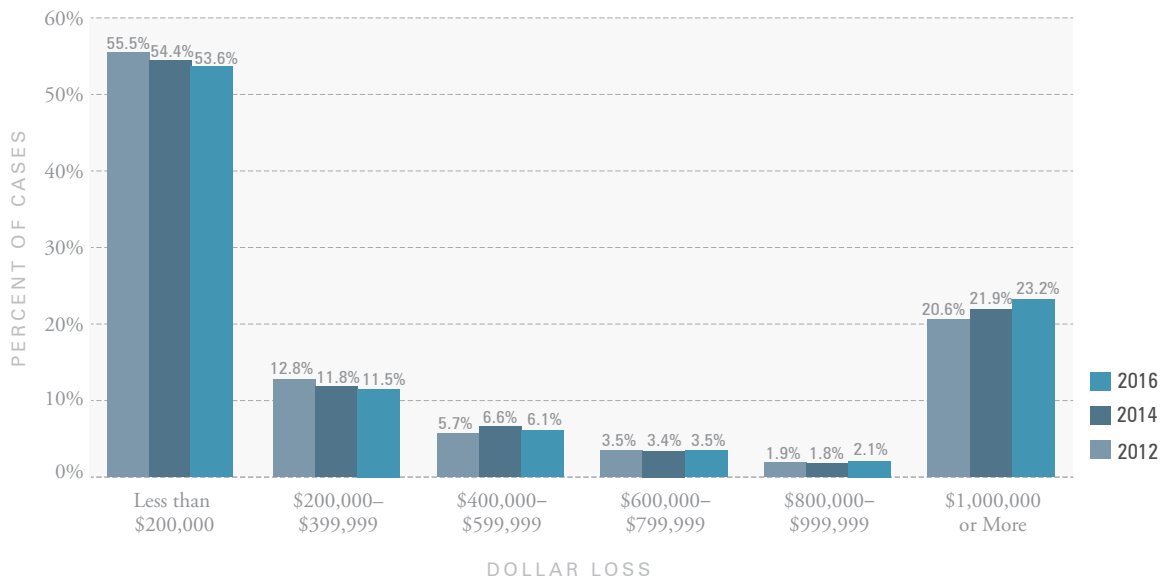
⁴ This 5% estimate is further supported by Jim Gee and Mark Button's report *The Financial Cost of Fraud 2015* (www.pkf.com/media/31640/PKF-The-financial-cost-of-fraud-2015.pdf), which reviews numerous fraud cost calculations computed by various organizations and arrives at an average fraud cost to organizations of 5.6%.

2,410 cases of occupational fraud in our study exceeded \$6.3 billion.⁵ This is an enormous sum, especially considering these cases represent just a tiny sliver of the thousands, or even millions, of frauds that likely took place throughout the world during the period of our survey (January 2014 through October 2015). We cannot determine from this number what global fraud losses truly are, but we can be confident those losses dwarf the known \$6.3 billion, most likely by a factor of hundreds or even thousands. In addition, this \$6.3 billion total only reflects direct losses suffered by the victim organizations; it does not include indirect costs, such as reputational harm or loss of stakeholder relationships, so the true total loss represented by these cases is likely much higher.

Distribution of Losses

Figure 2 shows the overall distribution of the dollar losses caused by the cases in our study; while approximately 54% caused less than \$200,000 in damage, more than 23% resulted in a loss of at least \$1 million.

Figure 2: Distribution of Dollar Losses



The overall average, or mean, loss caused by the frauds in this study was \$2.7 million.⁶ However, throughout this report we use median calculations, rather than the mean, when we report losses. Because the extremely large cases included in our study tend to skew the mean losses disproportionately upward, we believe the median loss better represents a typical fraud case. The median loss for all cases in our study was \$150,000, with a quartile distribution as follows:

25 th Percentile	50 th Percentile	75 th Percentile
\$30,000	\$150,000	\$800,000

Even viewing the losses reported to us through a conservative lens, a typical loss of \$150,000 per fraud can be devastating to many organizations, especially when combined with the indirect fallout that often accompanies a fraud scheme. Through this study, we hope to provide readers from all backgrounds—in the anti-fraud profession, in organizational management, in government and regulatory capacities, and in the media—an understanding of not only the potential scale of fraud’s impact, but also the damage suffered by its organizational victims and their stakeholders.

⁵ The total losses represented in our study were actually significantly higher than \$6.3 billion. However, our survey results included a few cases with losses so large that including them in the total loss figure may have enabled them to be identified. In order to avoid compromising the confidentiality of our survey participants, we have winsorized the top and bottom 1% of the data used in this total loss calculation (i.e., assigned all cases in the top 1% and bottom 1% the same value as the 99th and 1st percentile, respectively). While including those cases would increase the total loss amount figure substantially, we believe it prudent to both ensure these cases remain unidentified and conservatively report loss amounts.

⁶ As with the total loss figure above, the top and bottom 1% of the data were winsorized for purposes of this calculation.

How Occupational Fraud Is Committed



As part of our ongoing research into the methods used to commit fraud, the ACFE has developed the *Occupational Fraud and Abuse Classification System*, also known as the *Fraud Tree*. As reflected in the Fraud Tree graphic shown in Figure 3, there are three primary categories of

occupational fraud: asset misappropriation, corruption, and financial statement fraud.⁷ Each of these categories is broken down into several subcategories.

⁷ For definitions of each of these scheme types, please see the [Glossary of Terminology](#) on page 90.

The Evolution of the Fraud Tree

The Fraud Tree's genesis was in the first ACFE *Report to the Nation on Occupational Fraud and Abuse*, published in 1996. While analyzing the cases reported to us during our inaugural study on occupational fraud, we noted several patterns in the ways occupational fraud is committed. By organizing the cases according to these patterns, we discovered that almost all occupational fraud schemes fall into specific categories that target different functions and operations within a business or government entity. Based on these categories, we created a full classification system of occu-

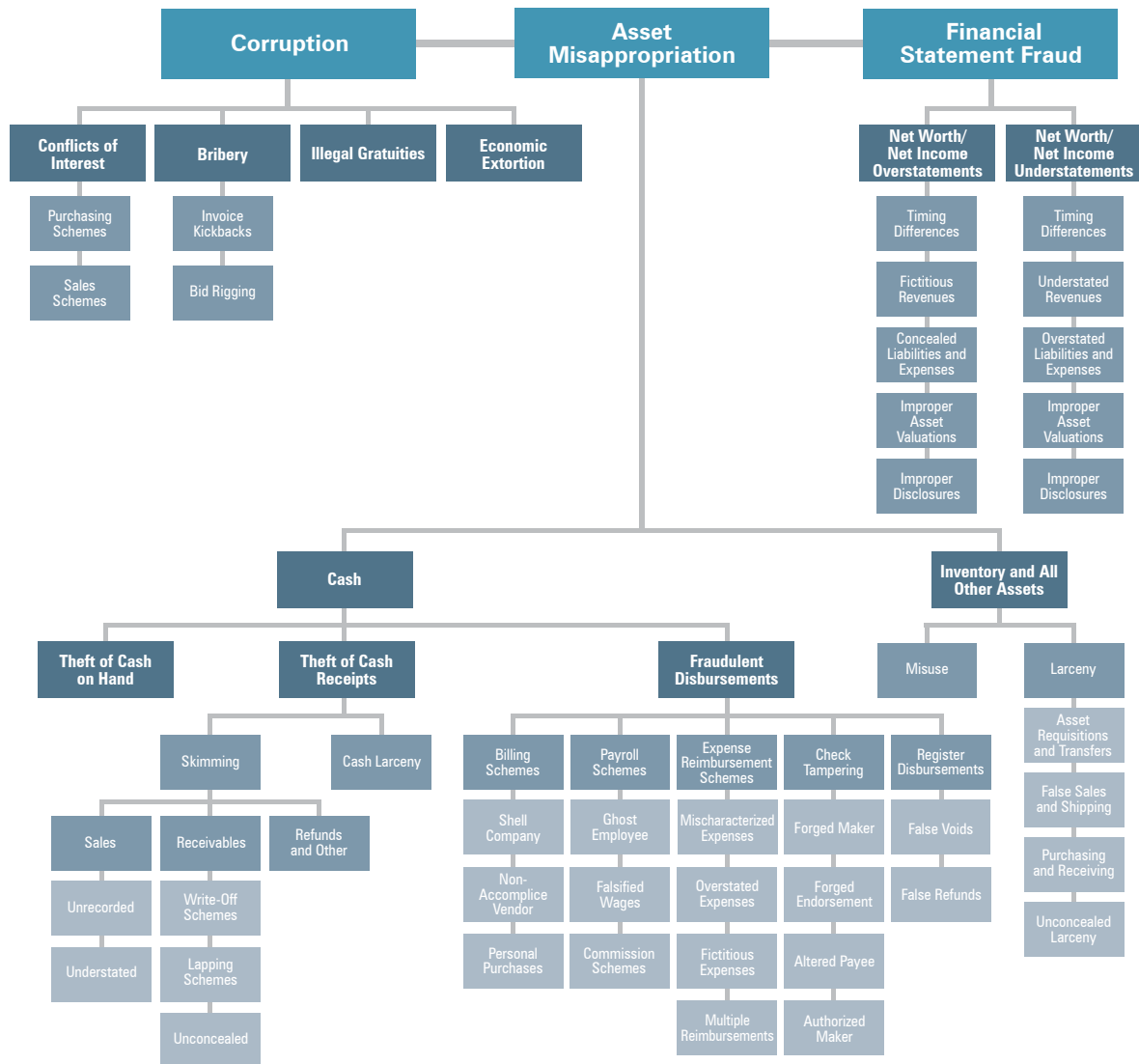
pational fraud schemes to help organizations understand their fraud risks and develop targeted anti-fraud controls.

The ACFE has made minor modifications to the Fraud Tree since its inception to improve its organizational structure and more closely align it with the thousands of cases analyzed over our two decades of research. For example:

- In 2012, we reorganized the schemes that target cash by adding a category called Theft of Cash Receipts, placing Skimming and Cash Larceny as sub-categories of this new group,

How Occupational Fraud Is Committed

Figure 3: Occupational Fraud and Abuse Classification System (Fraud Tree)



and adding another category for Theft of Cash on Hand. This change was intended to better classify the different operational points at which cash can be misappropriated from the victim organization (i.e., at receipt, when kept on hand, or during a disbursement transaction).

- Also in 2012, we renamed and refocused the category that currently appears as Financial Statement Fraud to better reflect the fact that all the schemes in this category involve some form of falsified or manipulated financial statements.
- This year, we modified the second-level category names that

appear under Financial Statement Fraud to clarify that these schemes affect the overall reported financial position and results (i.e., the net worth and net income) of the organization, rather than just the reported assets or revenue.

Even with these minor changes, however, the general structure of the Fraud Tree still holds, twenty years after its creation. This consistency reflects the notion that, while fraudsters embrace technology and devise new variations on schemes, the mechanisms and approaches employed by occupational fraud perpetrators fall into clear, time-tested categories.

How Occupational Fraud Is Committed

Asset misappropriation is by far the most common of the three primary categories of occupational fraud, consistently occurring in more than 83% of all cases reported to us (see Figure 4). These schemes tend to cause the lowest losses of the three categories, with a median loss of \$125,000 per scheme. On the opposite end of the spectrum is financial statement fraud, which was involved in less than 10% of the cases in our study, but which caused a median loss of \$975,000. Corruption schemes fall in the middle in terms of both frequency and losses. Approximately 35% of the cases we analyzed involved corruption, and these schemes caused a median loss of \$200,000.

Figure 4: Occupational Frauds by Category—Frequency

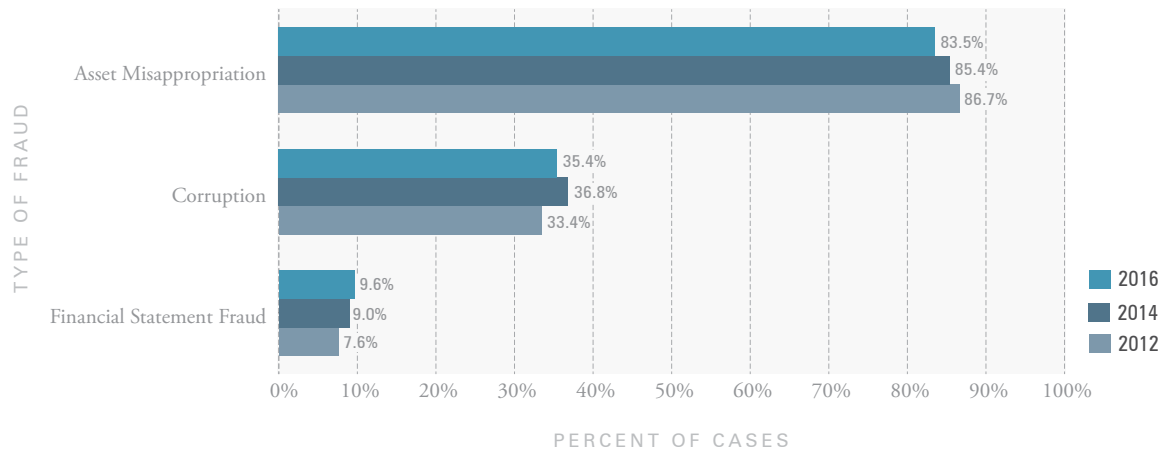
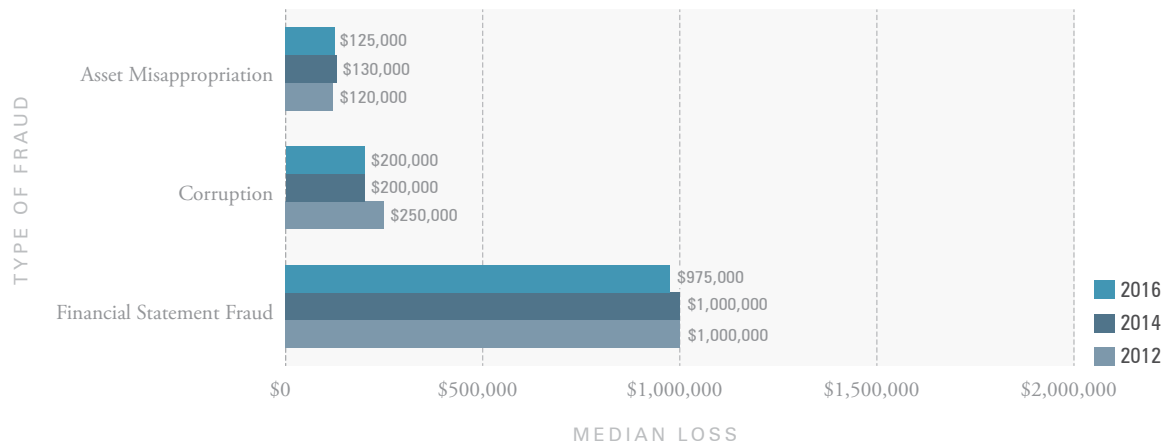


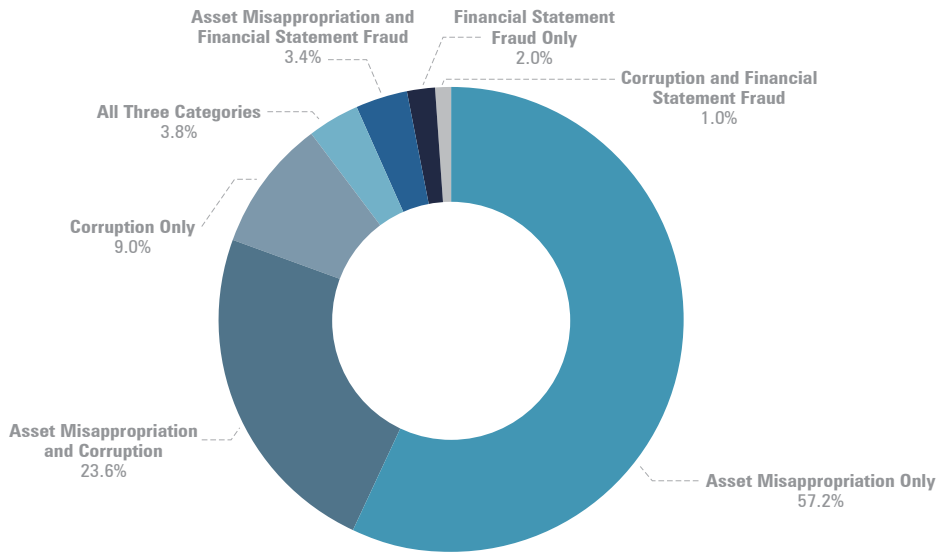
Figure 5: Occupational Frauds by Category—Median Loss



Overlap of Fraud Schemes

Many fraudsters do not limit themselves to a single type of fraud; they steal from their employers wherever the opportunity presents itself. Thus, many of the cases reported to us involved more than one of the three primary categories of occupational fraud. Figure 6 shows the overlap of those categories in the cases we reviewed. Of the 2,284 cases in which the respondent identified the scheme type(s), 727—or 31.8%—involved more than one major fraud category. The most common combination was asset misappropriation and corruption, which were co-perpetrated in 23.6% of cases. In 3.8% of cases, the perpetrator committed all three categories of fraud.

Figure 6: Overlap of Fraud Schemes

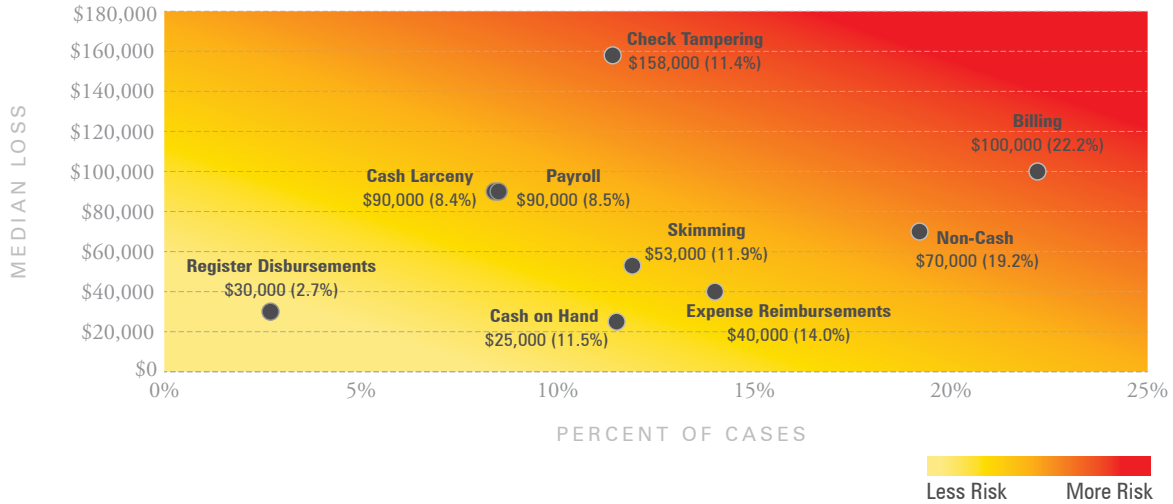


How Occupational Fraud Is Committed

Asset Misappropriation Sub-Schemes

Because such a high percentage of cases (83.5%) involved asset misappropriation, we expanded our analyses of these cases by examining the frequency and median loss of the principal asset misappropriation sub-schemes.⁸ Figure 7 reflects the relative risks posed by each of these sub-schemes, with billing schemes being the most common (22.2% of all cases) and check tampering⁹ being the most costly (median loss of \$158,000).

Figure 7: Frequency and Median Loss of Asset Misappropriation Sub-Schemes



Scheme Types by Region

To help organizations in different regions throughout the world benchmark their fraud occurrences and manage their fraud risks, we analyzed the prevalence of different forms of fraud in each geographic region (this analysis includes the nine asset misappropriation sub-schemes, as well as corruption and financial statement fraud). The results are reflected in Figures 8–16. In every region, corruption was one of the two most common scheme types, with either billing schemes or non-cash misappropriations taking the other top spot.

Figure 8: Scheme Types by Region—United States

Scheme	Number of Cases	Percent of Cases
Billing	289	27.8%
Corruption	258	24.9%
Non-Cash	174	16.8%
Skimming	167	16.1%
Expense Reimbursements	164	15.8%
Check Tampering	154	14.8%
Payroll	131	12.6%
Cash on Hand	125	12.0%
Cash Larceny	102	9.8%
Financial Statement Fraud	93	9.0%
Register Disbursements	29	2.8%

Figure 9: Scheme Types by Region—Sub-Saharan Africa

Scheme	Number of Cases	Percent of Cases
Corruption	138	48.4%
Billing	53	18.6%
Non-Cash	50	17.5%
Cash on Hand	47	16.5%
Skimming	42	14.7%
Cash Larceny	34	11.9%
Check Tampering	33	11.6%
Expense Reimbursements	26	9.1%
Financial Statement Fraud	16	5.6%
Payroll	11	3.9%
Register Disbursements	7	2.5%

⁸ For definitions of each of these sub-scheme types, please see the Glossary of Terminology on page 90.

⁹ For purposes of this report, the term *check tampering* includes manipulation of payments made via both paper-based checks and electronic payment methods.

How Occupational Fraud Is Committed

Figure 10: Scheme Types by Region—Asia-Pacific

Scheme	Number of Cases	Percent of Cases
Corruption	107	48.4%
Non-Cash	49	22.2%
Billing	45	20.4%
Expense Reimbursements	40	18.1%
Financial Statement Fraud	24	10.9%
Cash on Hand	23	10.4%
Check Tampering	22	10.0%
Skimming	20	9.0%
Cash Larceny	17	7.7%
Register Disbursements	10	4.5%
Payroll	6	2.7%

Figure 11: Scheme Types by Region—Latin America and the Caribbean

Scheme	Number of Cases	Percent of Cases
Corruption	51	45.5%
Non-Cash	26	23.2%
Billing	23	20.5%
Financial Statement Fraud	17	15.2%
Expense Reimbursements	16	14.3%
Check Tampering	14	12.5%
Skimming	10	8.9%
Payroll	9	8.0%
Cash on Hand	7	6.3%
Cash Larceny	3	2.7%
Register Disbursements	1	0.9%

Figure 12: Scheme Types by Region—Western Europe

Scheme	Number of Cases	Percent of Cases
Corruption	44	40.0%
Non-Cash	28	25.5%
Billing	21	19.1%
Expense Reimbursements	20	18.2%
Financial Statement Fraud	19	17.3%
Cash on Hand	10	9.1%
Check Tampering	9	8.2%
Payroll	9	8.2%
Cash Larceny	4	3.6%
Skimming	4	3.6%
Register Disbursements	3	2.7%

Figure 13: Scheme Types by Region—Eastern Europe and Western/Central Asia

Scheme	Number of Cases	Percent of Cases
Corruption	54	55.1%
Non-Cash	18	18.4%
Billing	18	18.4%
Financial Statement Fraud	17	17.3%
Cash on Hand	10	10.2%
Expense Reimbursements	10	10.2%
Cash Larceny	7	7.1%
Payroll	6	6.1%
Check Tampering	4	4.1%
Register Disbursements	3	3.1%
Skimming	2	2.0%

Figure 14: Scheme Types by Region—Southern Asia

Scheme	Number of Cases	Percent of Cases
Corruption	66	67.3%
Non-Cash	22	22.4%
Expense Reimbursements	14	14.3%
Billing	12	12.2%
Cash on Hand	9	9.2%
Financial Statement Fraud	8	8.2%
Cash Larceny	7	7.1%
Skimming	7	7.1%
Check Tampering	4	4.1%
Payroll	4	4.1%
Register Disbursements	2	2.0%

Figure 15: Scheme Types by Region—Canada

Scheme	Number of Cases	Percent of Cases
Billing	25	29.1%
Corruption	23	26.7%
Expense Reimbursements	15	17.4%
Non-Cash	14	16.3%
Financial Statement Fraud	11	12.8%
Cash on Hand	10	11.6%
Check Tampering	10	11.6%
Skimming	10	11.6%
Cash Larceny	9	10.5%
Payroll	9	10.5%
Register Disbursements	5	5.8%

How Occupational Fraud Is Committed

Figure 16: Scheme Types by Region—Middle East and North Africa

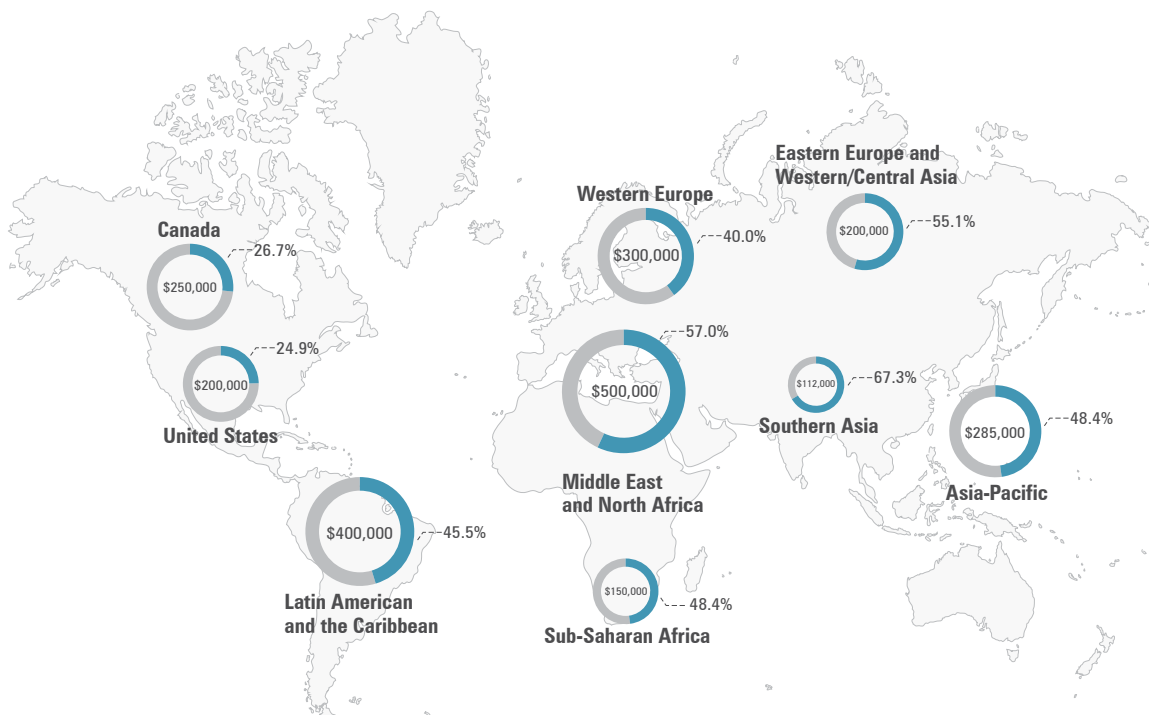
Scheme	Number of Cases	Percent of Cases
Corruption	45	57.0%
Non-Cash	21	26.6%
Cash on Hand	15	19.0%
Billing	12	15.2%
Expense Reimbursements	9	11.4%
Skimming	9	11.4%
Check Tampering	6	7.6%
Financial Statement Fraud	5	6.3%
Cash Larceny	4	5.1%
Payroll	2	2.5%
Register Disbursements	1	1.3%



Corruption Cases by Region

Corruption is a global problem. It is not limited to any particular region, and it affects organizations of all sizes, types, and industries, regardless of whether their operations cross jurisdictional lines. Nonetheless, there are certain places in the world where corruption is a greater risk than in others. We analyzed the corruption cases reported to us by region to highlight the relative risk of corruption worldwide (see Figure 17). Southern Asia had the largest percentage of reported corruption cases in our study, followed by the Middle East and North Africa. However, because this illustration reflects only those cases reported to us by the CFEs who took part in our survey, it is important to note that our data does not necessarily reflect the total amount of corruption that occurs in each region.

Figure 17: Frequency and Median Loss of Corruption Cases by Region*

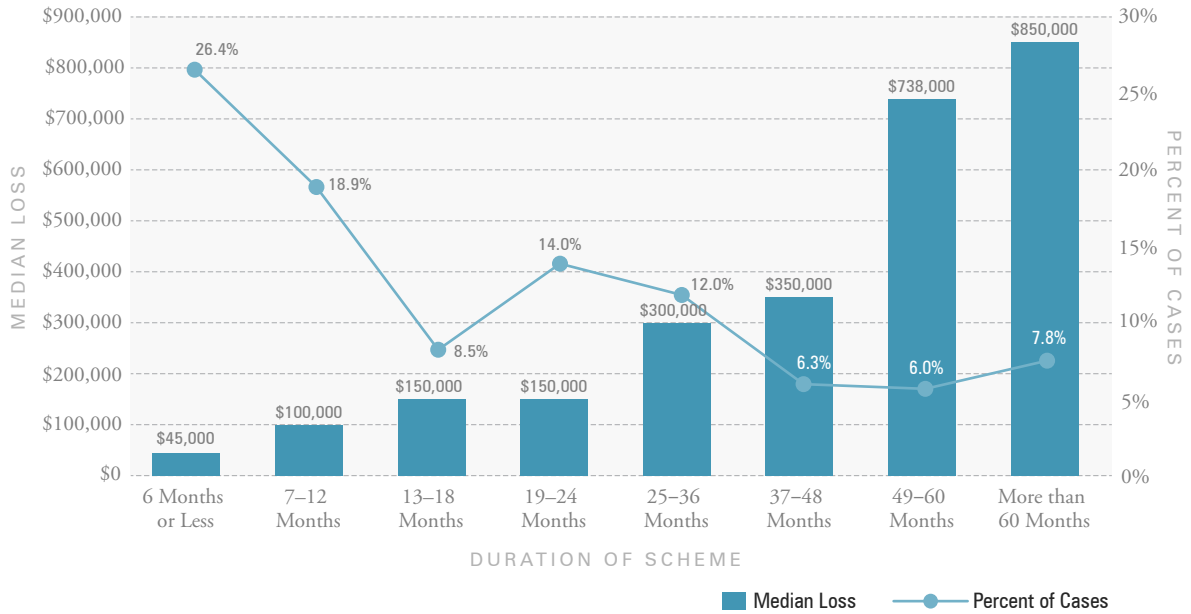


*For each region, the percentage shown indicates the proportion of cases in the region that involved corruption, and the dollar figure represents median loss for the corruption cases in the region.

Duration of Fraud Schemes

In addition to the type of scheme perpetrated, the loss caused by a fraud is also a function of how long it lasts before being detected. As shown in Figure 18, the longer perpetrators are able to go undetected, the more financial harm they are able to cause. The good news is that many fraud losses are mitigated by early detection, as more than one-quarter of cases were uncovered in the first six months. However, the median duration of the frauds in our study was 18 months, and more than 32% lasted at least two years before they were discovered.


Figure 18: Frequency and Median Loss Based on Duration of Fraud





THE LONGER AN OCCUPATIONAL FRAUD SCHEME GOES UNDETECTED, THE GREATER LOSSES TEND TO BE.

THE **MEDIAN DURATION** OF THE FRAUDS IN OUR STUDY WAS **18 MONTHS**.

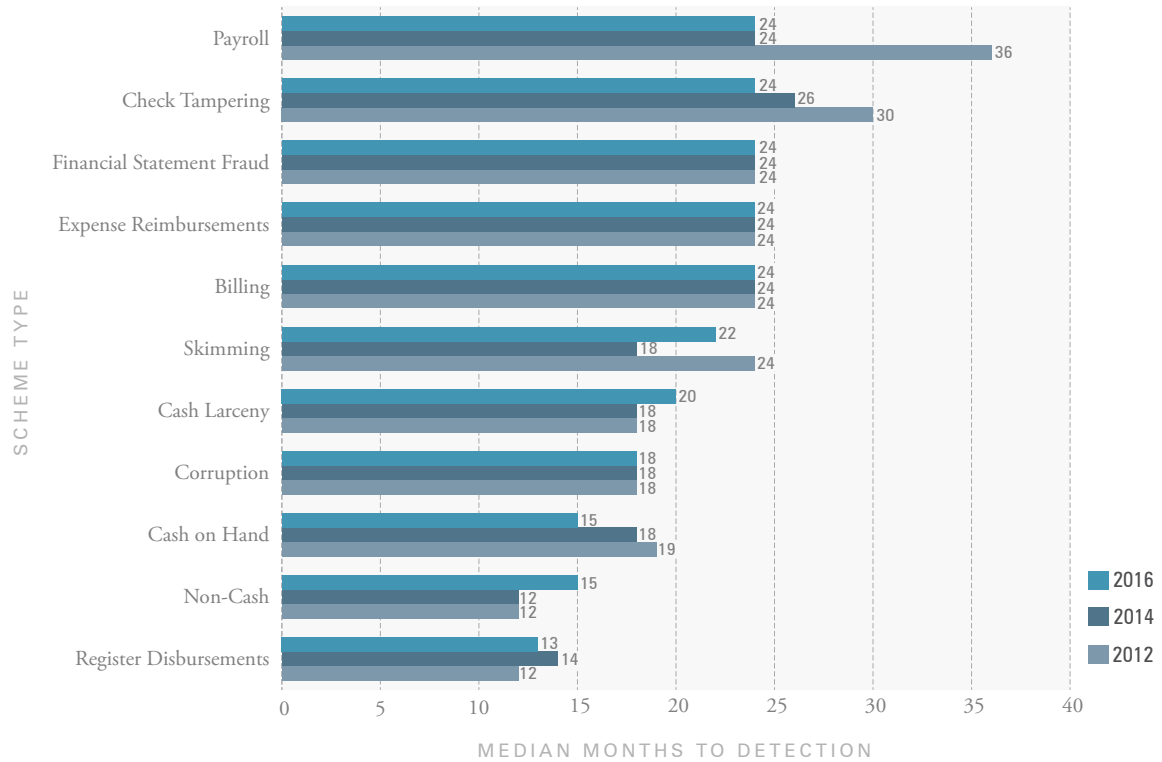


NEARLY **ONE-THIRD OF FRAUDS** LASTED AT LEAST TWO YEARS BEFORE THEY WERE DETECTED.

How Occupational Fraud Is Committed

We also examined the median duration of the different types of frauds. As seen in Figure 19, the typical cash register disbursement scheme was uncovered the most quickly, with a median duration of 13 months. In contrast, payroll, check tampering, financial statement fraud, expense reimbursements, and billing schemes all lasted a median of two years before being detected.

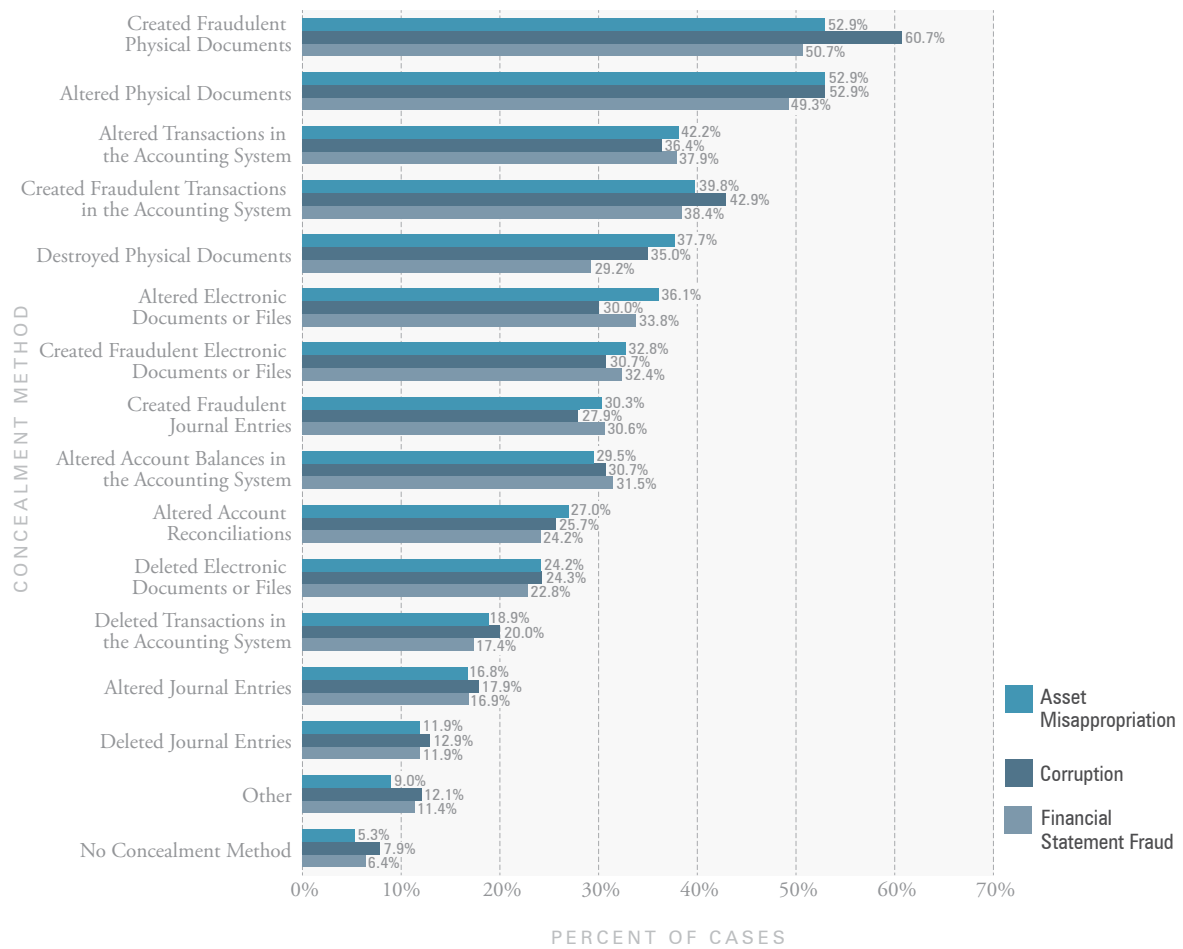
Figure 19: Median Duration of Fraud Based on Scheme Type



Concealment of Fraud Schemes

For the first time in this study, we asked survey respondents what steps the fraudsters took to conceal their schemes. Interestingly, the frequency of various concealment methods did not vary much based on the type of fraud perpetrated. Creating and altering physical documents were the most common concealment methods for all three categories, though the creation of fraudulent documents was slightly more common in corruption cases. Additionally, we found that the vast majority of fraudsters proactively attempted to conceal their schemes; only 5.5% of respondents noted that the perpetrator did not take any steps to hide the fraud.

Figure 20: Concealment Method by Scheme Type



Detection of Fraud Schemes



Most fraudsters do not undertake their schemes expecting they will get caught. When people choose to engage in occupational fraud, they typically know that they are risking their careers, reputations, and freedom by engaging in such misconduct. Therefore, increasing the likelihood that a scheme will be detected is a pillar of fraud prevention.

In addition to identifying patterns in how fraud is committed, we analyzed how occupational fraud schemes were initially detected. The overall frequency with which each detection method uncovered a fraud was generally consistent with previous reports, though we found that the frequency tended to vary based on an organization's size and location.

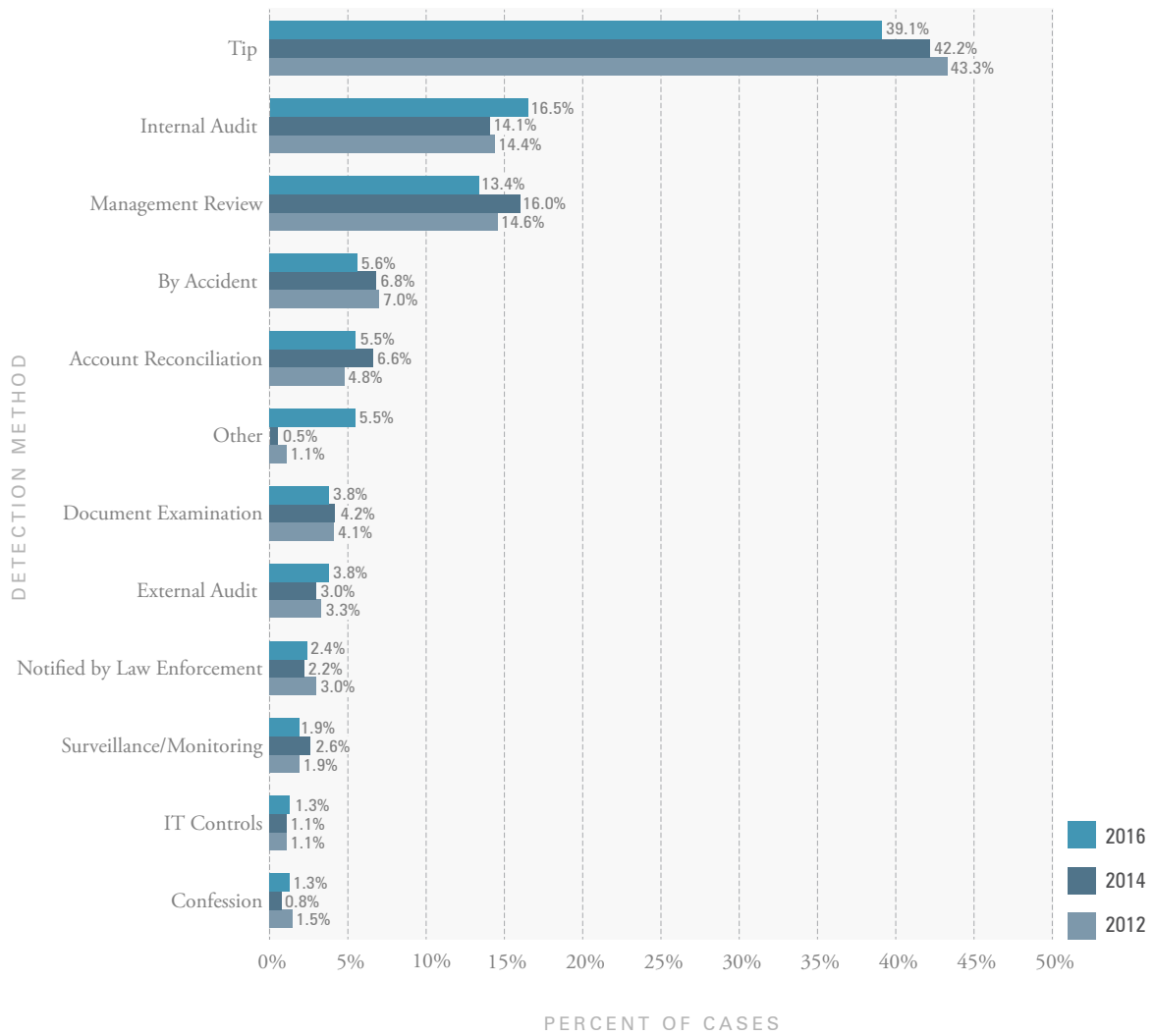
Also, by examining the relationship between detection methods and other factors, we identified ways for

anti-fraud professionals to enhance fraud detection at their own or their clients' organizations. For instance, by comparing the magnitude and duration of fraud schemes to the detection method, we determined that some detection methods tend to be associated with less costly frauds. Additionally, we found evidence that organizations can benefit from being proactive in detecting fraud.

Initial Detection of Occupational Frauds

Figure 21 shows the overall frequency of how schemes were initially detected, including a comparison from our 2014 and 2012 reports. As in previous years, tips were the most common detection method by a wide margin, accounting for 39.1% of cases. In the 2016 data, internal audit (16.5%) edged out management review (13.4%) as the second-most common detection method.

Figure 21: Initial Detection of Occupational Frauds



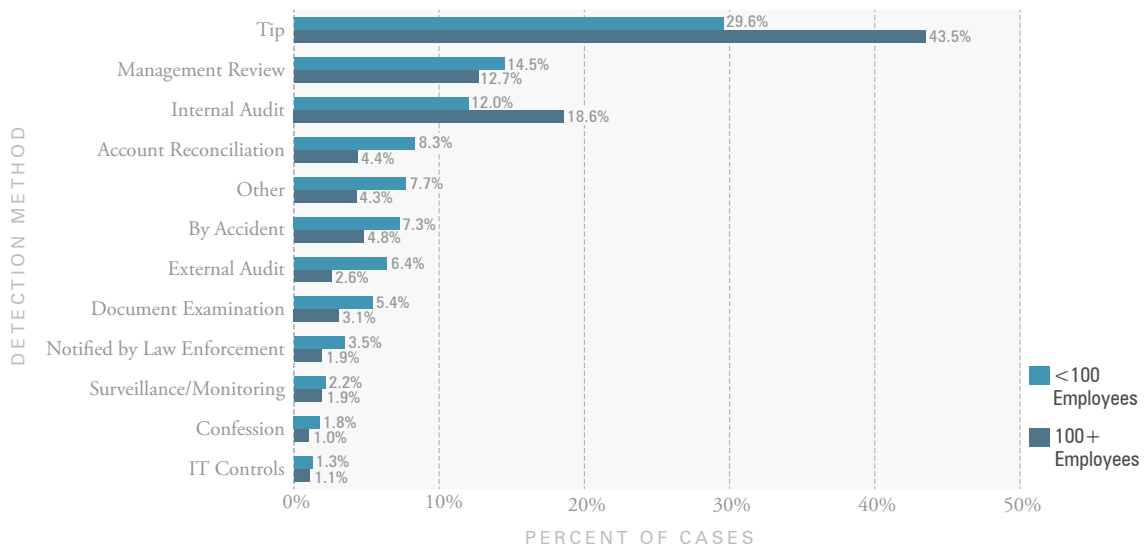
Detection of Fraud Schemes

Initial Detection of Frauds in Small Organizations

Our data shows that detection methods varied substantially between small organizations (i.e., those with fewer than 100 employees) and larger organizations. The starkest variation occurred with tips; small and larger organizations detected fraud via tip in 29.6% and 43.5% of cases, respectively. Similarly, internal audit was the detection method for 12% of cases at small organizations but 18.6% at larger organizations.

One possible explanation for these disparities is that the controls and procedures an organization has in place affect how fraud schemes are caught. [Figure 48 on page 39](#) shows that most small organizations do not have a reporting hotline (25.7%), while the majority of larger organizations do (74.1%). Internal audit departments are also less likely to exist at smaller organizations than at larger ones (38.6% and 88.3%, respectively). In place of tips, small organizations tend to detect more frauds through management review, account reconciliation, accident, external audit, and document examination.

Figure 22: Detection Method by Size of Victim Organization



Detection Method by Region

Each of the following tables shows initial detection methods for a particular geographic region. While tips are consistently the top detection method in every region, they are especially common in Southern Asia (53.1% of cases), Eastern Europe and Western/Central Asia (47.4%), and Asia-Pacific (45.2%). Internal audit was the second-most-common initial detection method in every region except Canada and the United States, where management review came in second.

Figure 23: Detection Method by Region—United States

Detection Method	Percent of Cases
Tip	37.0%
Management Review	14.3%
Internal Audit	14.1%
By Accident	7.2%
Account Reconciliation	6.1%
Other	5.5%
Document Examination	4.8%
External Audit	4.0%
Notified by Law Enforcement	2.5%
Surveillance/Monitoring	1.9%
IT Controls	1.5%
Confession	1.2%

Figure 24: Detection Method by Region—Sub-Saharan Africa

Detection Method	Percent of Cases
Tip	37.3%
Internal Audit	16.2%
Management Review	10.2%
Account Reconciliation	7.4%
By Accident	5.3%
Other	4.9%
Document Examination	4.9%
External Audit	4.9%
IT Controls	3.2%
Notified by Law Enforcement	2.1%
Surveillance/Monitoring	2.1%
Confession	1.4%

Figure 25: Detection Method by Region—Asia-Pacific

Detection Method	Percent of Cases
Tip	45.2%
Internal Audit	15.8%
Management Review	13.1%
External Audit	5.9%
Account Reconciliation	5.0%
Notified by Law Enforcement	4.5%
Other	4.1%
By Accident	2.7%
Document Examination	1.4%
Surveillance/Monitoring	0.9%
IT Controls	0.9%
Confession	0.5%

Figure 26: Detection Method by Region—Latin America and the Caribbean

Detection Method	Percent of Cases
Tip	36.9%
Internal Audit	19.8%
Management Review	17.1%
Other	8.1%
Account Reconciliation	4.5%
By Accident	3.6%
Document Examination	2.7%
External Audit	2.7%
Surveillance/Monitoring	2.7%
Confession	1.8%
Notified by Law Enforcement	0.0%
IT Controls	0.0%

Detection of Fraud Schemes

Figure 27: Detection Method by Region—
Western Europe

Detection Method	Percent of Cases
Tip	40.9%
Internal Audit	16.4%
Management Review	11.8%
Other	8.2%
Document Examination	4.5%
External Audit	4.5%
By Accident	3.6%
Surveillance/Monitoring	3.6%
Notified by Law Enforcement	2.7%
Account Reconciliation	1.8%
Confession	1.8%
IT Controls	0.0%

Figure 29: Detection Method by Region—
Southern Asia

Detection Method	Percent of Cases
Tip	53.1%
Internal Audit	21.9%
Management Review	9.4%
Account Reconciliation	5.2%
By Accident	4.2%
Surveillance/Monitoring	3.1%
Other	1.0%
External Audit	1.0%
Confession	1.0%
Document Examination	0.0%
Notified by Law Enforcement	0.0%
IT Controls	0.0%

Figure 31: Detection Method by Region—
Middle East and North Africa

Detection Method	Percent of Cases
Tip	39.2%
Internal Audit	25.3%
Management Review	11.4%
Account Reconciliation	5.1%
Other	5.1%
By Accident	3.8%
Document Examination	3.8%
Surveillance/Monitoring	3.8%
External Audit	1.3%
Notified by Law Enforcement	1.3%
IT Controls	0.0%
Confession	0.0%

Figure 28: Detection Method by Region—
Eastern Europe and Western/Central Asia

Detection Method	Percent of Cases
Tip	47.4%
Internal Audit	20.6%
Management Review	12.4%
Other	6.2%
Account Reconciliation	4.1%
By Accident	2.1%
Confession	2.1%
Document Examination	1.0%
External Audit	1.0%
Notified by Law Enforcement	1.0%
Surveillance/Monitoring	1.0%
IT Controls	1.0%

Figure 30: Detection Method by Region—
Canada

Detection Method	Percent of Cases
Tip	32.6%
Management Review	20.9%
Internal Audit	16.3%
Other	9.3%
By Accident	7.0%
Account Reconciliation	3.5%
Document Examination	3.5%
External Audit	2.3%
Notified by Law Enforcement	2.3%
IT Controls	1.2%
Confession	1.2%
Surveillance/Monitoring	0.0%

Median Loss and Median Duration by Detection Method

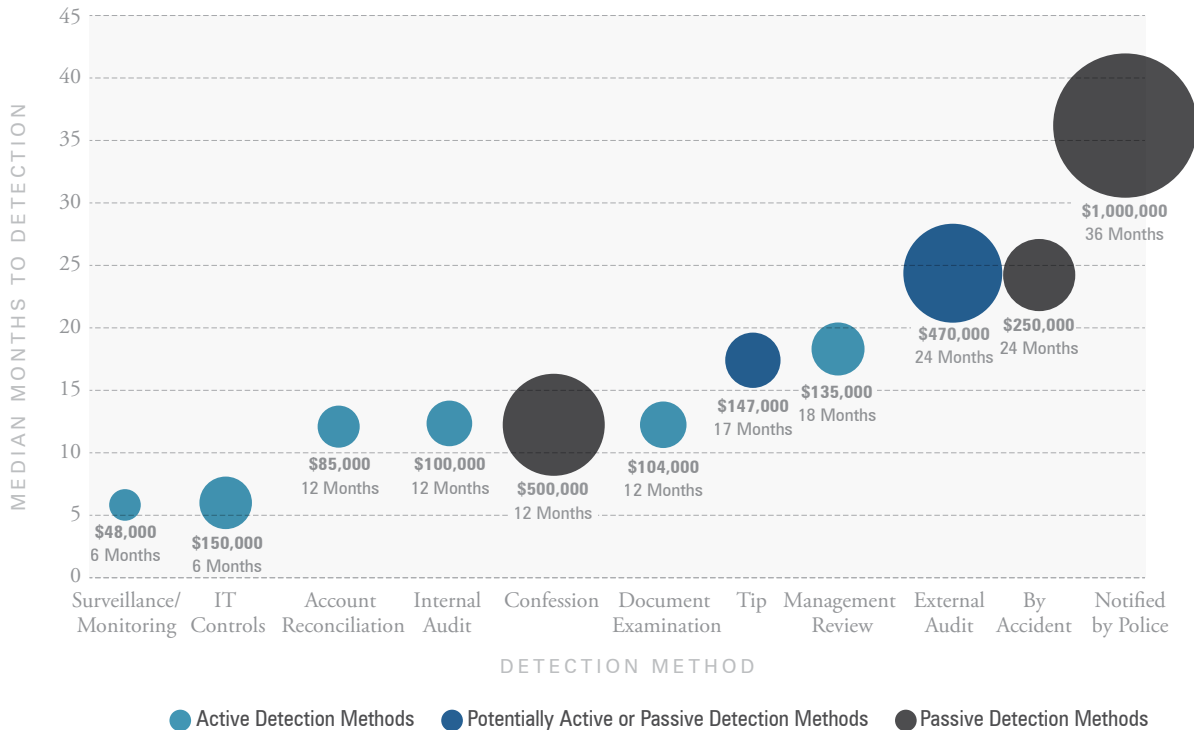
Our data suggests a relationship between the manner in which fraud is initially detected and the amount of financial harm the scheme causes. Figure 32 illustrates the relationship among the detection method, median loss, and median duration of occupational frauds. The detection methods are organized left-to-right in ascending order of duration, and the circles represent the size of the median loss. Additionally, the data points are color coded to indicate whether the detection method is primarily *active*, *passive*, or *potentially active* or *passive*.

An active detection method involves a deliberate search for misconduct at the direction of someone within the organization or an internal control or process that is instrumental in searching for fraud. In contrast, passive detection occurs when the organization learns of the fraud by accident, confession, or unsolicited notification by another party. Some detection methods could potentially be active or passive, depending on the circumstances. For example, tips might often be passive, but organizations that effectively promote reporting mechanisms actively cultivate such tips. Additionally, while the typical external audit is not primarily designed to look for fraud, an organization might procure an external audit in response to a suspected fraud, so external audits could be considered either active or passive, depending on the circumstances.

Our data shows that, generally speaking, frauds that are detected through active methods tend to be caught sooner and cause smaller losses than frauds that are detected passively. Of all detection methods, notification by law enforcement had both the highest associated median loss (\$1 million) and longest median duration (36 months). Of the active detection methods, the highest median loss (for IT controls) was \$150,000, while the longest median duration (for management review) was 18 months.

Thus, organizations might be able to reduce the duration and cost of fraud by implementing controls or processes that will increase the likelihood of active detection, such as active management review, attentive account reconciliation, and surveillance or monitoring techniques.

Figure 32: Median Loss and Median Duration by Detection Method



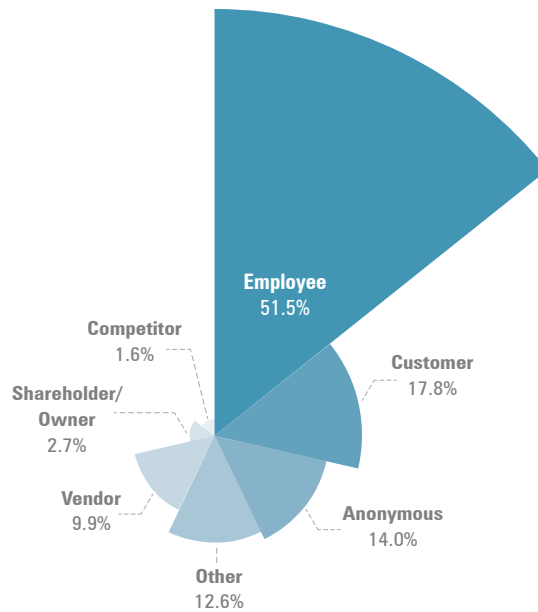
Detection of Fraud Schemes

Source of Tips

As tips are the most common detection method (see Figure 21 on page 21), it is helpful to know who is likely to report fraud to the organization. Employees, who provided 51.5% of tips, are generally the focus of reporting mechanisms at most organizations. However, anti-fraud professionals should remember that more than 40% of all tips came from non-employees. Customers (17.8%), vendors (9.9%), and other parties were significant sources of tips. Thus, some organizations might cultivate more tips by promoting fraud reporting mechanisms to multiple audiences.

Additionally, 14% of tips came from anonymous sources. Some jurisdictions restrict organizations from promoting anonymous reporting mechanisms, but organizations who choose not to have them risk losing sources who are not comfortable revealing their identity.

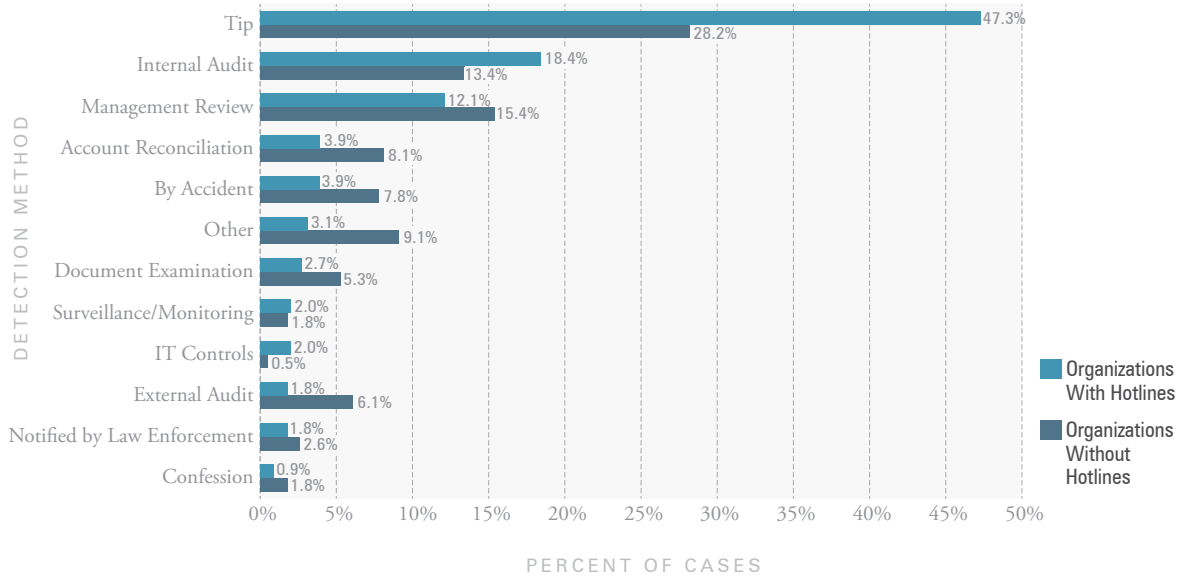
Figure 33: Source of Tips




Impact of Hotlines

One way to determine the effectiveness of reporting hotlines is to compare the percentage of cases that were initially detected via tip in organizations with and without hotlines. Figure 34 shows that while tips were the most common detection method regardless of whether a hotline was in place, schemes were detected by tip in 47.3% of cases at organizations that had hotlines, but in only 28.2% of cases at organizations without them.

Figure 34: Impact of Hotlines






**MORE THAN 40% OF ALL TIPS
CAME FROM NON-EMPLOYEES,
SUCH AS CUSTOMERS AND
VENDORS.**


PERCENT OF CASES DETECTED BY TIP

WITH HOTLINES



47%

WITHOUT HOTLINES



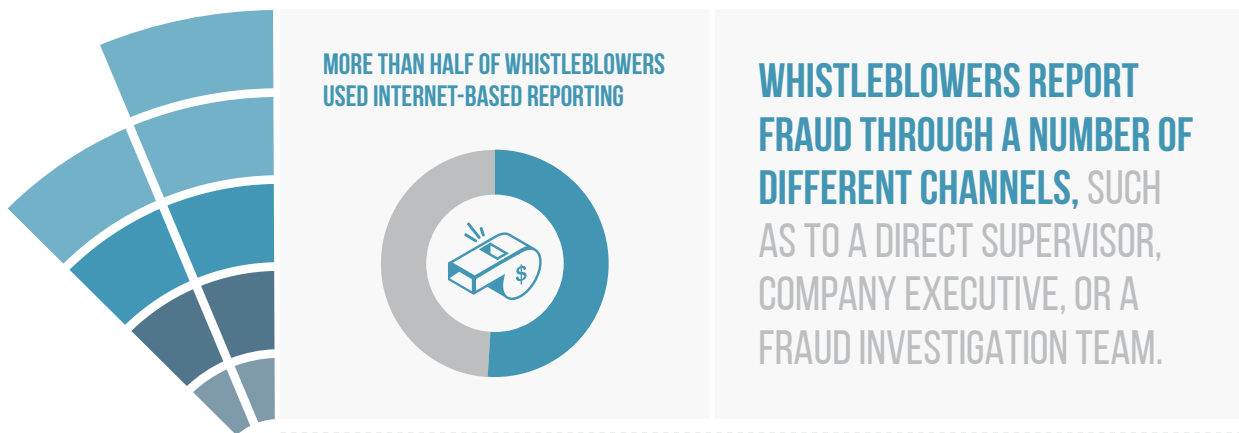
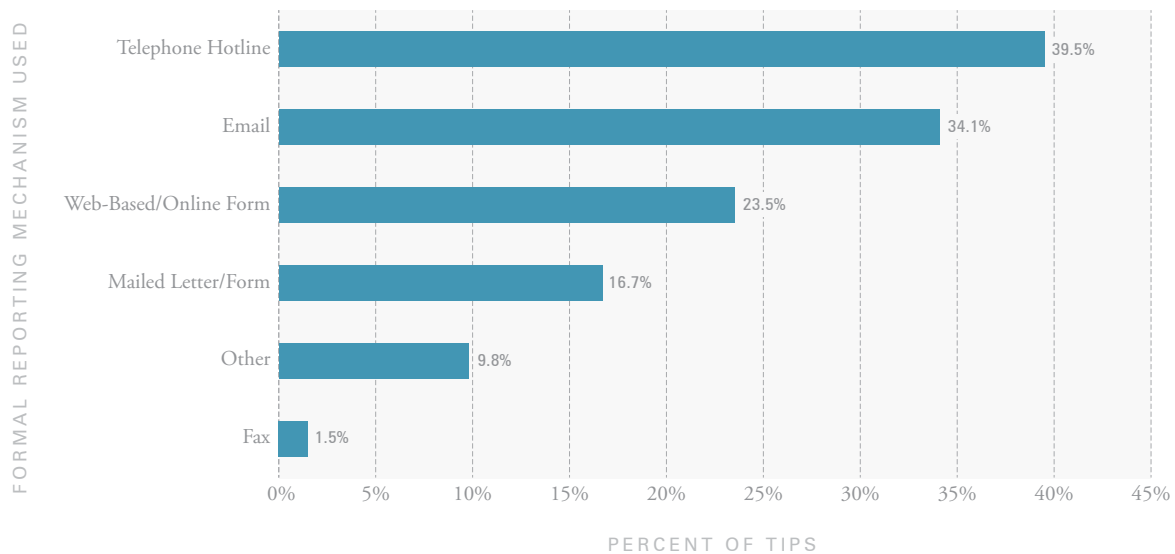
28%

Detection of Fraud Schemes

Formal Reporting Mechanism Used by Whistleblower

Our research has consistently established tips as a major source for detecting fraud, and the presence of hotlines can have a substantial impact on reporting (see Figure 34 on page 27). To understand how tips are received, we asked respondents to specify the formal reporting mechanism(s) used by the whistleblower. Figure 35 shows that while telephone hotlines are the most common (39.5% of tips received), more than half of complaints were submitted via the Internet (i.e., email and Web-based or online forms combined). The data suggests that organizations might benefit from offering multiple channels for reporting fraud.

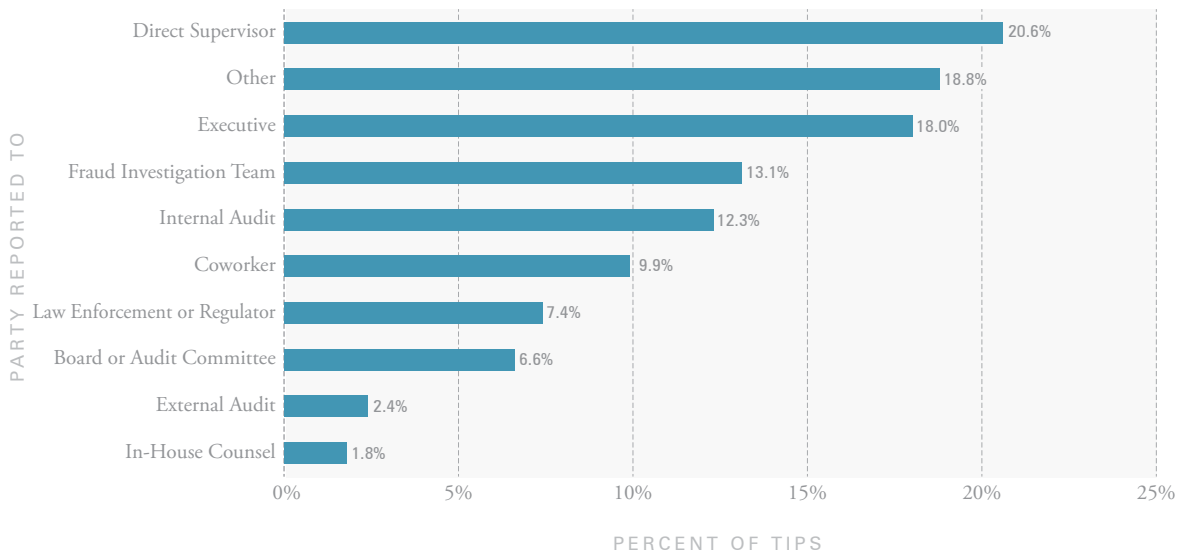
Figure 35: Formal Reporting Mechanism Used by Whistleblower



Party to Whom Whistleblower Initially Reported

A question that frequently emerges when organizations develop and promote reporting mechanisms is: Who should receive reports about fraud? To help provide some insight into this issue, we asked our survey participants to whom the whistleblowers in their cases reported their suspicions. Figure 36 shows that whistleblowers' direct supervisors were the party most commonly reported to (20.6%). Additionally, executives (18%), fraud investigation teams (13.1%), and internal audit departments (12.3%) each received a significant number of whistleblower reports. In reviewing the "other" category, many of the survey responses indicated that human resources or the owner of the organization were the party to whom the fraud was reported.

Figure 36: Party to Whom Whistleblower Initially Reported



Whistleblower Reports Vary Based on Department Where Fraud Occurs

Our findings indicate that the party to whom whistleblowers report tends to differ based on the perpetrator's department. Figure 37 includes the top three parties reported to for each department that made up 5% or more of the total responses. Throughout the organization, direct supervisors or executives are common parties who receive tips. However, when perpetrators were executives or in upper management, whistleblowers were most likely to report to

the board of directors or audit committee (22.2%) and second-most likely to report to law enforcement (20.4%). One explanation for this trend could be fear of retaliation from executives, making internal reporting to a direct supervisor risky. Additionally, reporting to internal audit was common when perpetrators worked in departments typically made up of junior staff, such as operations (18.6%) and customer services (16.7%), but not in other departments.

Figure 37: Top Three Parties to Whom Tips Were Reported Based on Perpetrator's Department

Operations	Accounting	Sales	Customer Service	Purchasing	Finance	Executive/Upper Management
Direct Supervisor (25.3%)	Executive (38.0%)	Direct Supervisor (26.4%)	Direct Supervisor (28.6%)	Executive (26.7%)	Direct Supervisor (21.1%)	Board or Audit Committee (22.2%)
Internal Audit (18.6%)	Direct Supervisor (27.1%)	Executive (20.8%)	Coworker (23.8%)	External Audit (26.7%)	Coworker (21.1%)	Law Enforcement or Regulator (20.4%)
Fraud Investigation Team or Executive (Both 15.7%)	Fraud Investigation Team (10.1%)	Fraud Investigation Team (17.0%)	Internal Audit (16.7%)	Direct Supervisor or Fraud Investigation Team (Both 16.7%)	Executive (21.1%)	Executive (18.5%)

Victim Organizations



As part of our survey, we asked respondents to provide demographic information regarding the victim organization, such as entity type, size, and industry. Using this data, we analyzed the frequency and median loss of fraud cases at various categories of victim organizations, as well as the types of schemes committed within different industries.

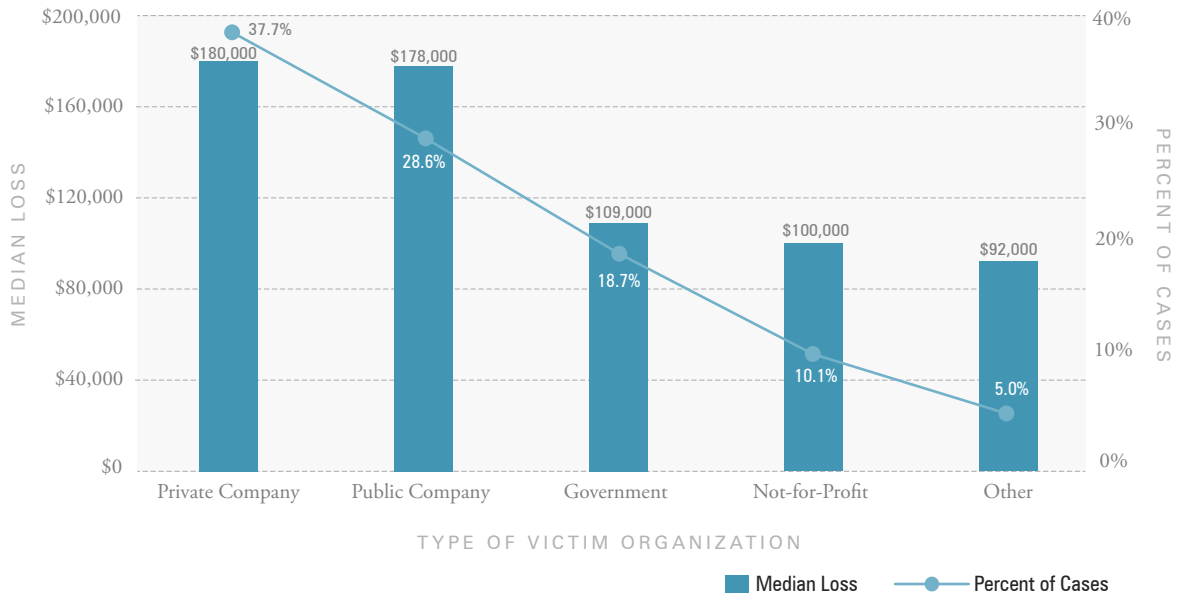
Additionally, we asked respondents what mechanisms the organization had in place to fight fraud when the scheme occurred. From these responses, we looked more closely at controls by victim size and region. This information enabled us to explore whether the presence

of specific anti-fraud controls corresponded with trends in median fraud losses and the time it took to detect schemes in organizations.

Type of Organization

Figure 38 depicts both the median loss and percent of cases based on the type of organization that was victimized. Privately held and publicly owned companies combined represented two-thirds of the cases reported to us. These organizations also suffered the greatest median losses (\$180,000 and \$178,000, respectively), which is consistent with our previous studies.

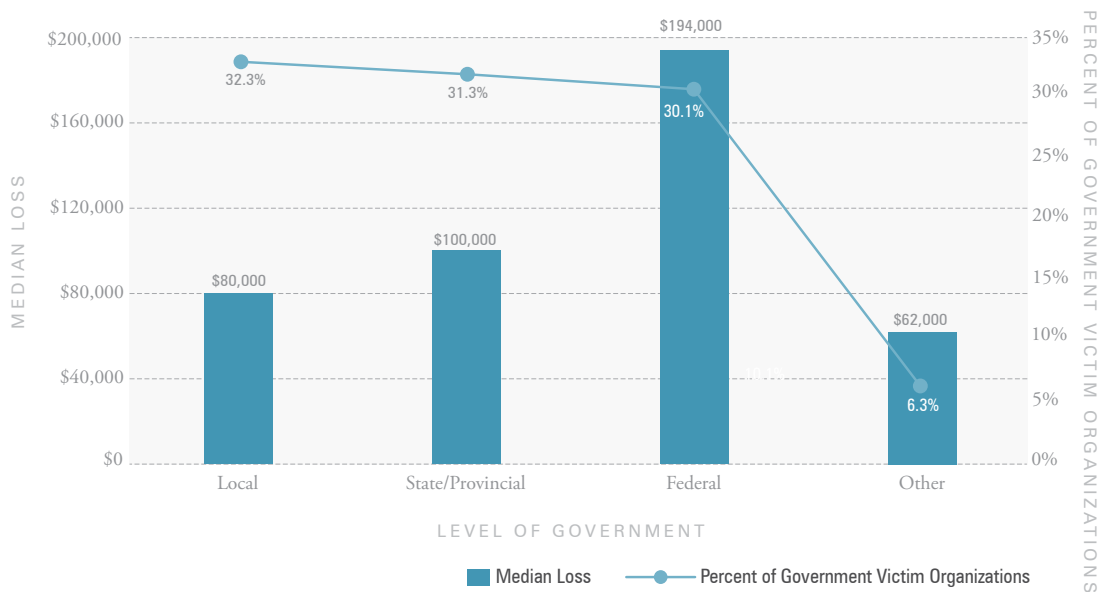
Figure 38: Type of Victim Organization—Frequency and Median Loss



Level of Government Organization

Because different levels of government vary in their operations and resources available to fight fraud, we further analyzed the government organizations that were victimized by the frauds in our study. Figure 39 shows the frequency of schemes for each level of government, as well as their respective median losses. Local, state/provincial, and federal governments accounted for approximately the same amount of cases (around 30% each). However, the highest median losses occurred at the federal level (\$194,000); median losses at the state/provincial and local levels were significantly smaller (\$100,000 and \$80,000, respectively).

Figure 39: Level of Government—Frequency and Median Loss



Victim Organizations

Size of Organization

Small organizations (defined as organizations with fewer than 100 employees for purposes of this report) were the most common victims in our study, at approximately 30%, while large organizations (those with more than 10,000 employees) accounted for the fewest cases, at 20.5%. Although both categories of organizations suffered a median loss of \$150,000, it is important to consider that small businesses would likely feel the impact of such a loss much more than large organizations.

Figure 40: Size of Victim Organization—Frequency

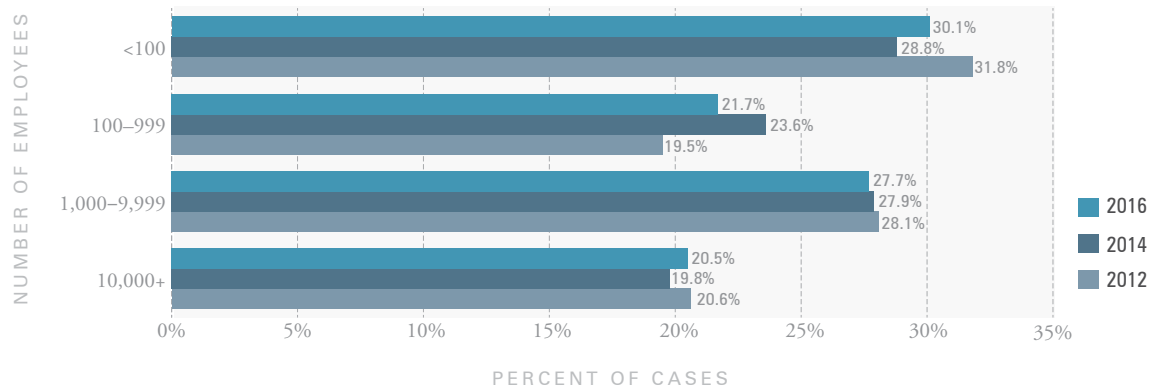
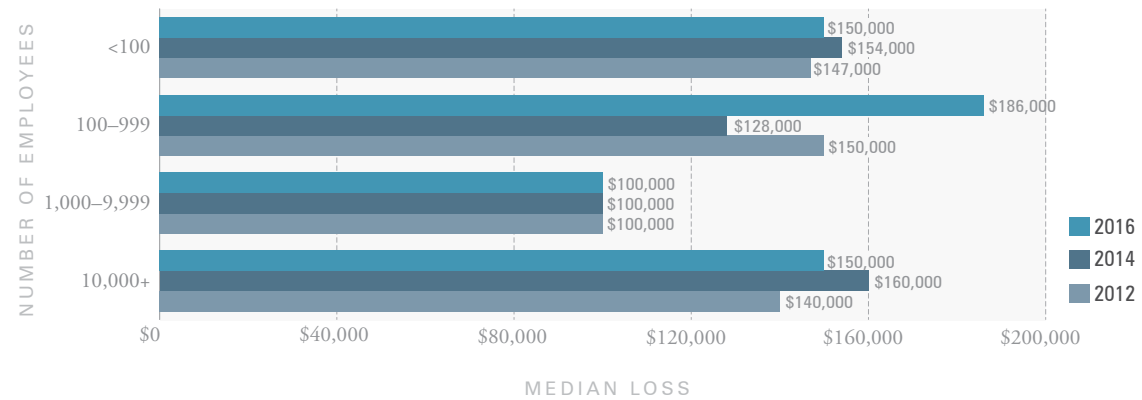


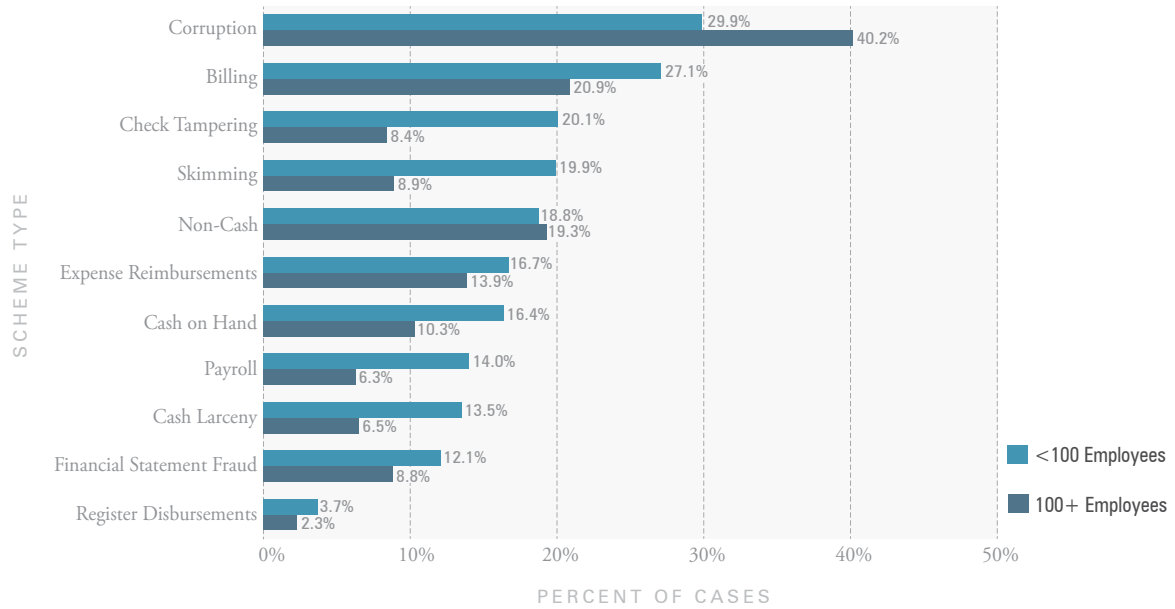
Figure 41: Size of Victim Organization—Median Loss



Methods of Fraud in Small Businesses

Figure 42 illustrates which fraud schemes small businesses were most susceptible to and which schemes occurred more often in larger organizations. Corruption was more prevalent in larger organizations (40.2% of cases) than in small businesses (29.9% of cases). In contrast, check tampering, skimming, payroll, and cash larceny schemes all occurred over twice as frequently in small businesses as in larger organizations.

Figure 42: Scheme Type by Size of Victim Organization

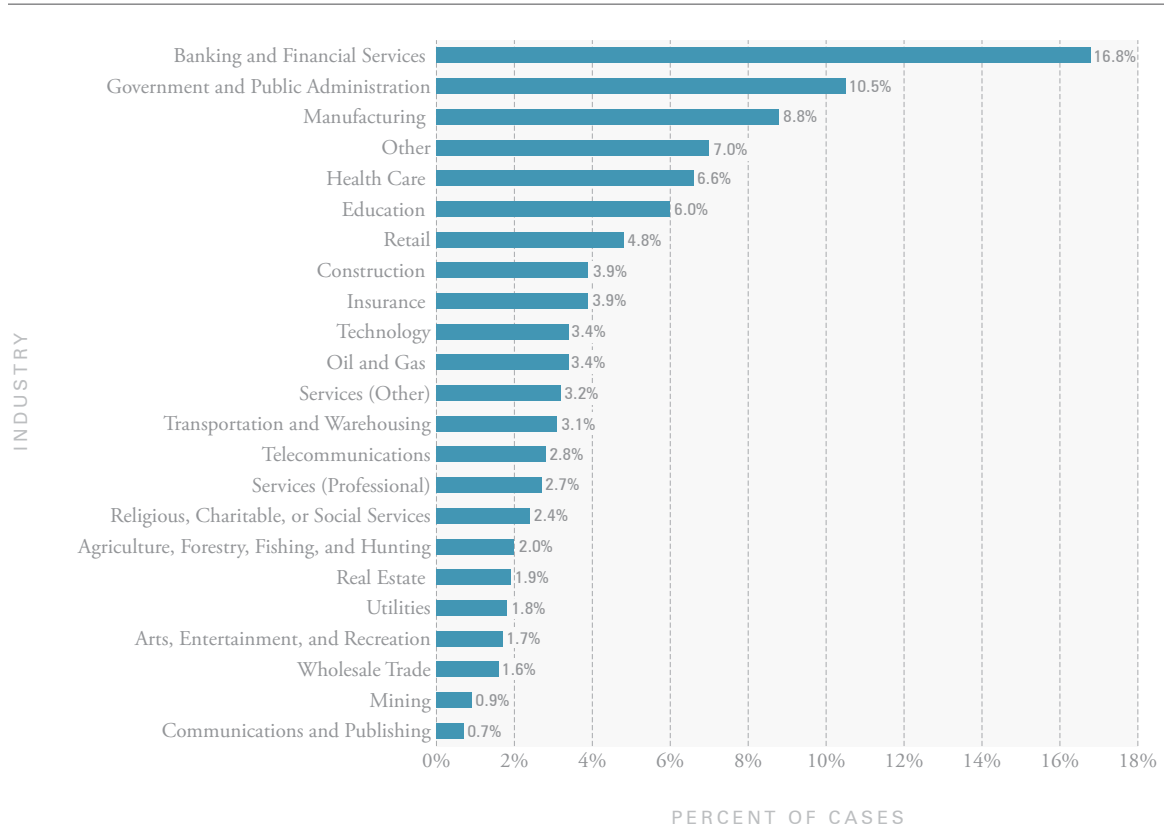


Victim Organizations

Industry of Organization

Figure 43 categorizes the cases reported to us by industry of the victim organization and Figure 44 displays the median loss of the various industries. Banking and financial services, government and public administration, and manufacturing were the most represented sectors in the fraud cases we examined. Conversely, industries with the lowest frequency of fraud cases included communications and publishing, mining, and wholesale trade. While this data shows the distribution of cases from our survey, it does not necessarily suggest that certain industries are more at risk of fraud than others. Our data was collected through a survey of Certified Fraud Examiners (CFEs), so this distribution primarily reflects the industries for which CFEs typically provide services.

Figure 43: Industry of Victim Organizations



Although mining and wholesale trade had among the fewest cases of any industry, those industries suffered the greatest median losses at \$500,000 and \$450,000, respectively. Other industries with significant median losses included professional services; agriculture, forestry, fishing, and hunting; and oil and gas. Banking and financial services reported the highest number of cases and had a median loss of \$192,000. Other highly represented industries with middle-of-the-road median losses included manufacturing (\$194,000), health care (\$120,000), and government and public administration (\$133,000). The education sector had the smallest median loss of \$62,000, but a significant number of reported cases.

Figure 44: Industry of Victim Organizations (Sorted by Median Loss)

Industry	Number of Cases	Percent of Cases	Median Loss
Mining	20	0.9%	\$500,000
Wholesale Trade	36	1.6%	\$450,000
Services (Professional)	60	2.7%	\$310,000
Agriculture, Forestry, Fishing, and Hunting	44	2.0%	\$300,000
Oil and Gas	74	3.4%	\$275,000
Construction	86	3.9%	\$259,000
Technology	74	3.4%	\$235,000
Communications and Publishing	16	0.7%	\$225,000
Real Estate	41	1.9%	\$200,000
Manufacturing	192	8.8%	\$194,000
Telecommunications	62	2.8%	\$194,000
Banking and Financial Services	368	16.8%	\$192,000
Transportation and Warehousing	68	3.1%	\$143,000
Government and Public Administration	229	10.5%	\$133,000
Health Care	144	6.6%	\$120,000
Insurance	85	3.9%	\$107,000
Utilities	40	1.8%	\$102,000
Other	153	7.0%	\$100,000
Services (Other)	70	3.2%	\$100,000
Retail	104	4.8%	\$85,000
Religious, Charitable, or Social Services	52	2.4%	\$82,000
Arts, Entertainment, and Recreation	37	1.7%	\$75,000
Education	132	6.0%	\$62,000

Victim Organizations

Schemes by Industry

Figure 45 is a heat map that represents the frequency of schemes in each industry that had at least 50 reported cases. Boxes are shaded based on the respective level of occurrence, with red boxes indicating extremely high-frequency risks and light yellow denoting the least common schemes. Billing, corruption, and non-cash misappropriation schemes were among the most common types of fraud in several industries. Conversely, certain schemes tended to be particularly high-risk in specific industries, such as skimming in educational organizations or check tampering in professional services firms and religious or charitable organizations.

Figure 45: Frequency of Schemes Based on Industry

Industry/Scheme	Banking and Financial Services	Government and Public Administration	Manufacturing	Health Care	Education	Retail	Construction	Insurance	Oil and Gas	Technology	Services (Other)	Transportation and Warehousing	Telecommunications	Services (Professional)	Religious, Charitable, or Social Services
Cases	368	229	192	144	132	104	86	85	74	74	70	68	62	60	52
Billing	9.5%	25.3%	32.8%	31.3%	34.1%	15.4%	27.9%	17.6%	20.3%	29.7%	22.9%	22.1%	12.9%	26.7%	25.0%
Cash Larceny	11.1%	7.9%	5.2%	9.7%	13.6%	12.5%	8.1%	4.7%	4.1%	5.4%	15.7%	4.4%	1.6%	13.3%	9.6%
Cash on Hand	17.9%	10.5%	8.3%	11.1%	17.4%	11.5%	7.0%	4.7%	9.5%	8.1%	22.9%	5.9%	4.8%	20.0%	13.5%
Check Tampering	9.5%	9.2%	13.5%	14.6%	7.6%	9.6%	10.5%	17.6%	4.1%	5.4%	18.6%	10.3%	6.5%	31.7%	25.0%
Corruption	37.5%	38.4%	40.4%	30.6%	31.8%	32.7%	36.0%	28.2%	43.6%	44.6%	28.6%	51.5%	41.9%	16.7%	28.8%
Expense Reimbursements	5.4%	15.7%	22.9%	20.1%	15.9%	8.7%	20.9%	9.4%	10.8%	27.0%	12.9%	8.8%	19.4%	16.7%	25.0%
Financial Statement Fraud	12.0%	7.9%	10.9%	13.2%	5.3%	5.8%	17.4%	7.1%	6.8%	12.2%	17.1%	5.9%	9.7%	11.7%	3.8%
Non-Cash	10.6%	14.8%	30.2%	13.2%	17.4%	32.7%	22.1%	5.9%	17.6%	18.9%	22.9%	29.4%	38.7%	10.0%	13.5%
Payroll	3.8%	13.5%	11.5%	9.7%	7.6%	3.8%	16.3%	5.9%	8.1%	2.7%	11.4%	7.4%	3.2%	11.7%	13.5%
Register Disbursements	2.7%	1.7%	5.7%	2.1%	1.5%	8.7%	1.2%	0.0%	0.0%	1.4%	5.7%	2.9%	3.2%	1.7%	1.9%
Skimming	6.8%	14.0%	8.3%	12.5%	25.0%	17.3%	15.1%	10.6%	8.1%	5.4%	21.4%	11.8%	6.5%	18.3%	19.2%



Corruption Cases by Industry

Figure 46 displays the total number of cases in each industry, along with the percentage of those cases categorized as corruption schemes. Although mining only had 20 total cases reported, 11 of those cases (55%) involved corruption, which was the highest percent of corruption cases in any industry. Other industries with fairly high proportions of corruption schemes included the transportation and warehousing, oil and gas, and manufacturing sectors. In contrast, professional services (e.g., medical, legal, and accounting services) reported the fewest number of corruption cases, with only 16.7% of cases.

Figure 46: Corruption Cases by Industry

Industry	Total Number of Cases	Number of Corruption Cases	Percent of Cases Involving Corruption
Mining	20	11	55.0%
Transportation and Warehousing	68	35	51.5%
Oil and Gas	74	36	48.6%
Manufacturing	192	93	48.4%
Technology	74	33	44.6%
Telecommunications	62	26	41.9%
Wholesale Trade	36	15	41.7%
Government and Public Administration	229	88	38.4%
Banking and Financial Services	368	138	37.5%
Communications and Publishing	16	6	37.5%
Other	153	57	37.3%
Agriculture, Forestry, Fishing, and Hunting	44	16	36.4%
Construction	86	31	36.0%
Utilities	40	14	35.0%
Real Estate	41	14	34.1%
Retail	104	34	32.7%
Education	132	42	31.8%
Health Care	144	44	30.6%
Arts, Entertainment, and Recreation	37	11	29.7%
Religious, Charitable, or Social Services	52	15	28.8%
Services (Other)	70	20	28.6%
Insurance	85	24	28.2%
Services (Professional)	60	10	16.7%

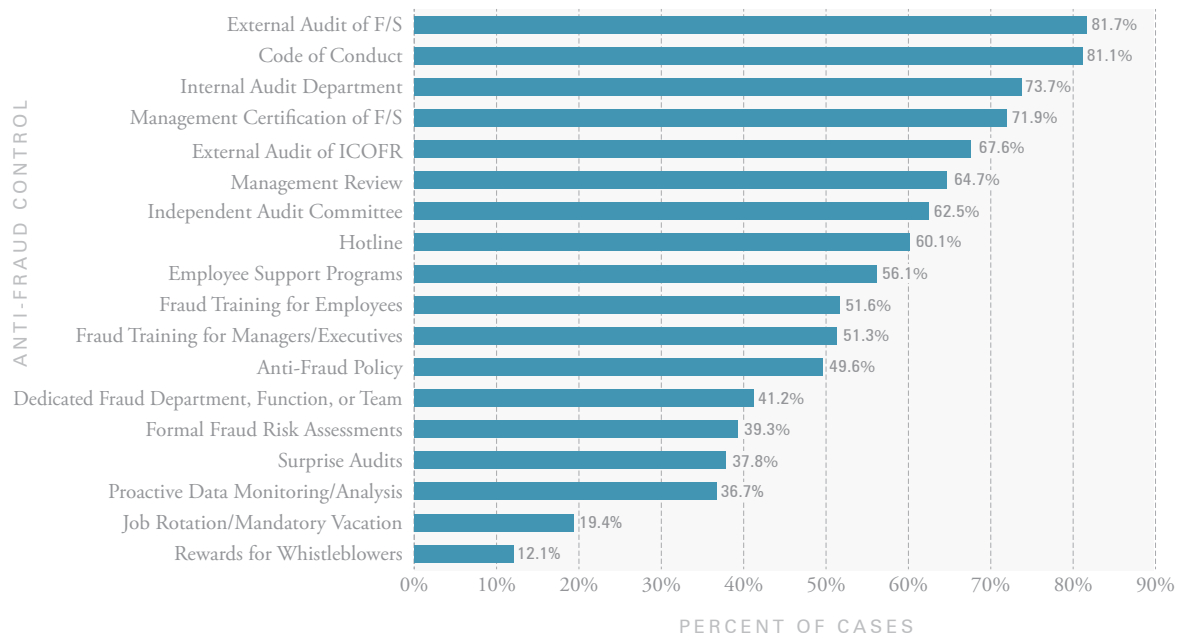
Victim Organizations

Anti-Fraud Controls at the Victim Organization

While the presence of internal controls does not provide guaranteed protection against fraud, it can help to both mitigate losses and deter some potential fraudsters by enhancing the perception of detection. Consequently, enacting internal controls specifically designed to prevent and detect fraud is a vital part of a fraud risk management program.

Many organizations find it useful to benchmark their anti-fraud controls against their peers, both in terms of what mechanisms are being employed and the effectiveness of those approaches. To help with this endeavor, we asked respondents about the anti-fraud controls in place at the victim organization at the time the fraud occurred. As shown in Figure 47, almost 82% of victim organizations underwent external audits of their financial statements by independent audit firms. Despite being the most common anti-fraud control analyzed, such audits are not designed specifically to find fraud and were responsible for detecting less than 4% of the frauds in our study (see Figure 21 on page 21). Conversely, hotlines were only present in 60.1% of the victim organizations, and yet we know that tips are consistently and overwhelmingly the most common method by which frauds are detected.

Figure 47: Frequency of Anti-Fraud Controls



The following key applies to Figures 47 and 48:

External Audit of F/S = Independent External Audits of the Organization's Financial Statements

Management Certification of F/S = Management Certification of the Organization's Financial Statements

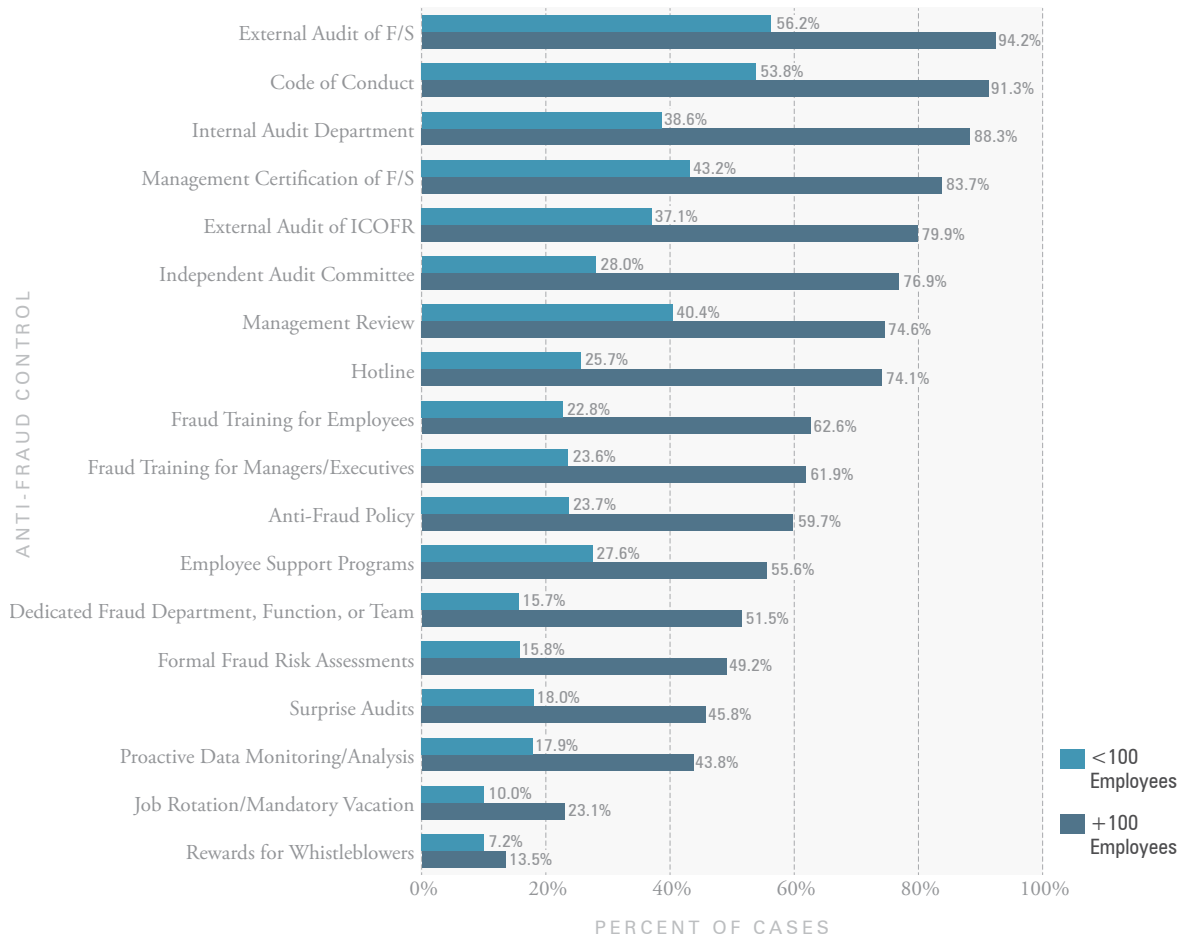
External Audit of ICOFR = Independent External Audits of the Organization's Internal Controls Over Financial Reporting

Anti-Fraud Controls at Small Businesses

When it comes to fighting fraud, many small businesses face an uphill battle. These entities not only incur losses as large as bigger organizations (see Figure 41 on page 32), but they typically have fewer resources with which to combat this threat. The combination of these factors leaves small businesses particularly vulnerable to occupational fraud. In addition, the working environment and limited staff size in many small businesses often relies upon, and even requires, an increased level of trust among the individuals performing daily operational tasks. As most anti-fraud professionals know, trust is not an internal control. In fact, trust in the wrong person can lead to disaster.

Figure 48 illustrates the frequency with which small businesses enact anti-fraud controls, compared to their larger counterparts. While it is understandable that small businesses do not have the resources necessary to invest in some of the more expensive internal controls noted, several controls—such as a code of conduct, management review procedures, and fraud training for staff members—can be implemented with minimal investment. Small businesses are uniquely susceptible to fraud in many ways, but there are opportunities for improvement in the measures they use to mitigate this risk.

Figure 48: Frequency of Anti-Fraud Controls by Size of Victim Organization



Trends in the Implementation of Anti-Fraud Controls

The general implementation rates of anti-fraud controls have remained notably consistent throughout our studies, although we have seen a slight uptick in the prevalence of each control over the last six years.* The most notable changes have been in the implementation rates of hotlines and fraud training for employees, which have increased approximately 9% and 8%, respectively, since 2010.

On the other end of the spectrum, the percentage of organizations that undergo external audits of their financial statements has remained relatively flat, with less than a 1% increase over the same period.

Figure 49: Change in Implementation Rates of Anti-Fraud Controls

Control	2010 Implementation Rate	2016 Implementation Rate	Change from 2010–2016
Hotline	51.2%	60.1%	8.9%
Fraud Training for Employees	44.0%	51.6%	7.6%
Anti-Fraud Policy	42.8%	49.6%	6.8%
Code of Conduct	74.8%	81.1%	6.3%
Management Review	58.8%	64.7%	5.9%
Surprise Audits	32.3%	37.8%	5.6%
Fraud Training for Managers/Executives	46.2%	51.3%	5.2%
Independent Audit Committee	58.4%	62.5%	4.1%
Management Certification of Financial Statements	67.9%	71.9%	4.0%
Rewards for Whistleblowers	8.6%	12.1%	3.5%
Job Rotation/Mandatory Vacation	16.6%	19.4%	2.8%
External Audit of Internal Controls over Financial Reporting	65.4%	67.6%	2.2%
Employee Support Programs	54.6%	56.1%	1.5%
External Audit of Financial Statements	80.9%	81.7%	0.8%

**For this analysis, we only included those controls with categories that have been consistently included in our studies since 2010. Formal fraud risk assessments and proactive data monitoring/analysis were added to our study in 2012 and 2014, respectively. And prior to 2014, internal audit department and dedicated fraud department, function, or team were combined into a single control category. Thus, these controls are omitted from the table above.*

Anti-Fraud Controls by Region

Regional variations in the implementation rates of anti-fraud controls provide both an interesting perspective regarding what organizations around the world are doing to manage fraud risk and helpful benchmarks for organizations' anti-fraud programs. Figures 50–58 reflect the frequency of anti-fraud controls reported in the cases based on the geographical region of the victim organization.

For all regions, external audits of the financial statements, code of conduct, and management certification of the financial statements were among the five most common controls. Internal audit departments also ranked among the top five for all regions except Canada, where it was the sixth most common control. On the opposite end of the spectrum, both job rotation/mandatory vacations and rewards for whistleblowers were at the very bottom of the list for every region.

In addition to this consistency, there were also some notable differences in the implementation rates of controls in the different jurisdictions. For example, employee support programs are among the most common controls in Canada and the United States (with implementation rates of 77% and 66%, respectively), but were among the least common controls in Southern Asia, Eastern Europe and Western/Central Asia, and the Middle East and North Africa. And while rewards for whistleblowers was the least common control across all regions, the implementation rate varied widely—from just 1.1% of organizations in Eastern Europe and Western/Central Asia to about 20% of organizations in both Southern Asia and Sub-Saharan Africa.

Figure 50: Frequency of Anti-Fraud Controls—United States

Control	Percent of Cases
Code of Conduct	74.6%
External Audit of Financial Statements	74.2%
Employee Support Programs	66.0%
Management Certification of Financial Statements	64.1%
Internal Audit Department	61.4%
External Audit of Internal Controls over Financial Reporting	59.8%
Management Review	57.3%
Hotline	54.5%
Independent Audit Committee	53.8%
Fraud Training for Managers/Executives	50.5%
Fraud Training for Employees	49.3%
Anti-Fraud Policy	45.2%
Formal Fraud Risk Assessments	36.5%
Dedicated Fraud Department, Function, or Team	36.4%
Proactive Data Monitoring/Analysis	35.5%
Surprise Audits	31.8%
Job Rotation/Mandatory Vacation	16.1%
Rewards for Whistleblowers	12.7%

Figure 52: Frequency of Anti-Fraud Controls—Asia-Pacific

Control	Percent of Cases
External Audit of Financial Statements	88.2%
Code of Conduct	85.2%
Internal Audit Department	83.6%
Management Certification of Financial Statements	80.2%
External Audit of Internal Controls over Financial Reporting	74.5%
Management Review	72.3%
Independent Audit Committee	68.1%
Hotline	65.7%
Fraud Training for Employees	53.3%
Fraud Training for Managers/Executives	50.8%
Employee Support Programs	48.3%
Anti-Fraud Policy	46.8%
Dedicated Fraud Department, Function, or Team	44.4%
Surprise Audits	41.8%
Proactive Data Monitoring/Analysis	34.4%
Formal Fraud Risk Assessments	32.6%
Job Rotation/Mandatory Vacation	24.6%
Rewards for Whistleblowers	7.8%

Figure 51: Frequency of Anti-Fraud Controls—Sub-Saharan Africa

Control	Percent of Cases
Code of Conduct	91.9%
Internal Audit Department	91.6%
External Audit of Financial Statements	88.8%
Management Certification of Financial Statements	79.9%
External Audit of Internal Controls over Financial Reporting	77.6%
Management Review	70.8%
Independent Audit Committee	69.6%
Hotline	67.7%
Anti-Fraud Policy	59.2%
Fraud Training for Employees	55.0%
Fraud Training for Managers/Executives	55.0%
Surprise Audits	52.8%
Employee Support Programs	50.9%
Formal Fraud Risk Assessments	48.2%
Dedicated Fraud Department, Function, or Team	47.7%
Proactive Data Monitoring/Analysis	38.5%
Job Rotation/Mandatory Vacation	27.8%
Rewards for Whistleblowers	20.0%

Figure 53: Frequency of Anti-Fraud Controls—Latin American and the Caribbean

Control	Percent of Cases
Code of Conduct	84.8%
External Audit of Financial Statements	82.2%
Internal Audit Department	80.7%
Management Certification of Financial Statements	70.3%
Hotline	68.5%
Management Review	68.0%
Independent Audit Committee	67.6%
External Audit of Internal Controls over Financial Reporting	66.7%
Fraud Training for Employees	54.4%
Fraud Training for Managers/Executives	53.9%
Anti-Fraud Policy	51.0%
Employee Support Programs	46.1%
Dedicated Fraud Department, Function, or Team	44.0%
Formal Fraud Risk Assessments	38.1%
Surprise Audits	31.0%
Proactive Data Monitoring/Analysis	26.7%
Job Rotation/Mandatory Vacation	17.0%
Rewards for Whistleblowers	6.1%

Victim Organizations

Figure 54: Frequency of Anti-Fraud Controls—
Western Europe

Control	Percent of Cases
External Audit of Financial Statements	88.8%
Code of Conduct	83.7%
Internal Audit Department	80.7%
Management Certification of Financial Statements	76.9%
External Audit of Internal Controls over Financial Reporting	75.8%
Independent Audit Committee	75.7%
Management Review	74.7%
Hotline	63.8%
Anti-Fraud Policy	54.9%
Fraud Training for Employees	54.4%
Fraud Training for Managers/Executives	52.5%
Employee Support Programs	51.2%
Formal Fraud Risk Assessments	49.0%
Dedicated Fraud Department, Function, or Team	45.8%
Proactive Data Monitoring/Analysis	37.1%
Surprise Audits	27.4%
Job Rotation/Mandatory Vacation	17.7%
Rewards for Whistleblowers	6.1%

Figure 56: Frequency of Anti-Fraud Controls—
Southern Asia

Control	Percent of Cases
External Audit of Financial Statements	96.5%
Internal Audit Department	94.7%
Management Certification of Financial Statements	91.6%
Code of Conduct	89.0%
External Audit of Internal Controls over Financial Reporting	86.7%
Independent Audit Committee	82.6%
Management Review	79.8%
Hotline	70.5%
Fraud Training for Managers/Executives	61.2%
Anti-Fraud Policy	58.1%
Surprise Audits	57.1%
Fraud Training for Employees	54.9%
Dedicated Fraud Department, Function, or Team	53.8%
Proactive Data Monitoring/Analysis	44.7%
Formal Fraud Risk Assessments	44.6%
Employee Support Programs	34.6%
Job Rotation/Mandatory Vacation	23.5%
Rewards for Whistleblowers	20.3%

Figure 55: Frequency of Anti-Fraud Controls—
Eastern Europe and Western/Central Asia

Control	Percent of Cases
Code of Conduct	90.9%
External Audit of Financial Statements	88.2%
Internal Audit Department	82.8%
Management Certification of Financial Statements	75.0%
Independent Audit Committee	70.3%
Management Review	70.1%
External Audit of Internal Controls over Financial Reporting	69.4%
Hotline	65.6%
Anti-Fraud Policy	61.4%
Fraud Training for Employees	60.5%
Fraud Training for Managers/Executives	56.8%
Dedicated Fraud Department, Function, or Team	50.0%
Formal Fraud Risk Assessments	45.3%
Proactive Data Monitoring/Analysis	39.0%
Surprise Audits	35.3%
Employee Support Programs	28.6%
Job Rotation/Mandatory Vacation	17.6%
Rewards for Whistleblowers	1.1%

Figure 57: Frequency of Anti-Fraud Controls—
Canada

Control	Percent of Cases
External Audit of Financial Statements	83.3%
Management Certification of Financial Statements	79.7%
Code of Conduct	79.2%
Employee Support Programs	77.0%
External Audit of Internal Controls over Financial Reporting	65.8%
Internal Audit Department	64.7%
Management Review	61.5%
Independent Audit Committee	59.2%
Hotline	52.5%
Anti-Fraud Policy	39.0%
Dedicated Fraud Department, Function, or Team	38.6%
Fraud Training for Employees	38.0%
Proactive Data Monitoring/Analysis	37.2%
Formal Fraud Risk Assessments	35.5%
Fraud Training for Managers/Executives	35.4%
Surprise Audits	31.1%
Job Rotation/Mandatory Vacation	16.2%
Rewards for Whistleblowers	8.0%

Figure 58: Frequency of Anti-Fraud Controls—Middle East and North Africa

Control	Percent of Cases
External Audit of Financial Statements	95.9%
Internal Audit Department	90.9%
Management Certification of Financial Statements	82.4%
Code of Conduct	81.1%
External Audit of Internal Controls over Financial Reporting	80.6%
Independent Audit Committee	75.7%
Management Review	73.2%
Hotline	62.2%
Surprise Audits	61.6%
Anti-Fraud Policy	50.7%
Fraud Training for Employees	47.9%
Proactive Data Monitoring/Analysis	46.5%
Dedicated Fraud Department, Function, or Team	44.6%
Fraud Training for Managers/Executives	44.4%
Formal Fraud Risk Assessments	41.7%
Employee Support Programs	25.4%
Job Rotation/Mandatory Vacation	24.6%
Rewards for Whistleblowers	14.9%



Effectiveness of Controls

While the presence of anti-fraud controls helps deter some potential frauds, measuring the preventive value of individual controls is extremely difficult, if not impossible. However, anti-fraud professionals often need to make a business case to management for additional resources to address fraud risks. To help illustrate the potential return on investment for individual anti-fraud controls, we have examined the comparative median fraud loss and time to detection for frauds in organizations based on whether they had each of the 18 anti-fraud controls in place at the time the fraud occurred (see Figures 59 and 60 on page 44).

Across the board, the presence of anti-fraud controls was correlated with lower losses and quicker fraud detection. The 36.7% of victim organizations that were using proactive data monitoring and analysis techniques as part of their anti-fraud program suffered fraud losses that were 54% lower and detected the frauds in half the time compared to organizations that did not use this technique. Management review and the presence of a hotline were both similarly correlated with regard to lower losses (50% reduction) and decreased time to detect the scheme (50% reduction), and most of the other controls showed similar reductions, as well.

The two controls that most stood out in these comparisons, however, were external audits of the financial statements (which was the most implemented control) and rewards for whistleblowers (which was the least implemented control). These two controls fell toward the bottom of the list with regard to both measures of effectiveness. While they were correlated with lower fraud losses and durations, the correlation was notably smaller for both measures than the other controls analyzed.

Victim Organizations

Figure 59: Median Loss Based on Presence of Anti-Fraud Controls

Control	Percent of Cases	Control in Place	Control Not in Place	Percent Reduction
Proactive Data Monitoring/Analysis	36.7%	\$92,000	\$200,000	54.0%
Management Review	64.7%	\$100,000	\$200,000	50.0%
Hotline	60.1%	\$100,000	\$200,000	50.0%
Management Certification of Financial Statements	71.9%	\$104,000	\$205,000	49.3%
Surprise Audits	37.8%	\$100,000	\$195,000	48.7%
Dedicated Fraud Department, Function, or Team	41.2%	\$100,000	\$192,000	47.9%
Job Rotation/Mandatory Vacation	19.4%	\$89,000	\$170,000	47.6%
External Audit of Internal Controls over Financial Reporting	67.6%	\$105,000	\$200,000	47.5%
Fraud Training for Managers/Executives	51.3%	\$100,000	\$190,000	47.4%
Fraud Training for Employees	51.6%	\$100,000	\$188,000	46.8%
Formal Fraud Risk Assessments	39.3%	\$100,000	\$187,000	46.5%
Employee Support Programs	56.1%	\$100,000	\$183,000	45.4%
Anti-Fraud Policy	49.6%	\$100,000	\$175,000	42.9%
Internal Audit Department	73.7%	\$123,000	\$215,000	42.8%
Code of Conduct	81.1%	\$120,000	\$200,000	40.0%
Rewards for Whistleblowers	12.1%	\$100,000	\$163,000	38.7%
Independent Audit Committee	62.5%	\$114,000	\$180,000	36.7%
External Audit of Financial Statements	81.7%	\$150,000	\$175,000	14.3%

Figure 60: Median Duration of Fraud Based on Presence of Anti-Fraud Controls

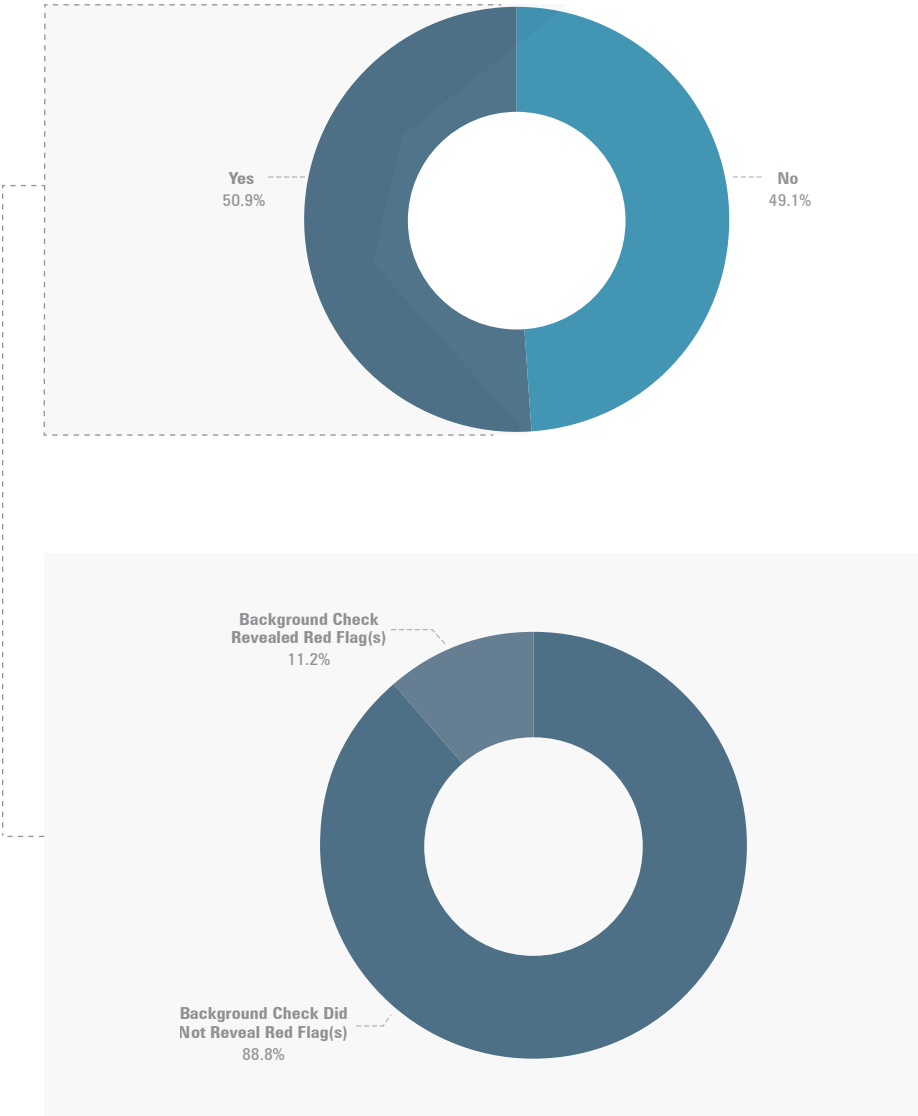
Control	Percent of Cases	Control in Place	Control Not in Place	Percent Reduction
Surprise Audits	37.8%	12 Months	24 Months	50.0%
Proactive Data Monitoring/Analysis	36.7%	12 Months	24 Months	50.0%
Dedicated Fraud Department, Function, or Team	41.2%	12 Months	24 Months	50.0%
Hotline	60.1%	12 Months	24 Months	50.0%
Formal Fraud Risk Assessments	39.3%	12 Months	24 Months	50.0%
Management Review	64.7%	12 Months	24 Months	50.0%
Independent Audit Committee	62.5%	12 Months	24 Months	50.0%
Internal Audit Department	73.7%	12 Months	24 Months	50.0%
External Audit of Internal Controls over Financial Reporting	67.6%	12 Months	24 Months	50.0%
Management Certification of Financial Statements	71.9%	12 Months	24 Months	50.0%
Code of Conduct	81.1%	13 Months	24 Months	45.8%
Job Rotation/Mandatory Vacation	19.4%	10 Months	18 Months	44.4%
Anti-Fraud Policy	49.6%	12 Months	21 Months	42.9%
Fraud Training for Employees	51.6%	12 Months	20 Months	40.0%
Fraud Training for Managers/Executives	51.3%	12 Months	20 Months	40.0%
Rewards for Whistleblowers	12.1%	11 Months	18 Months	38.9%
External Audit of Financial Statements	81.7%	15 Months	24 Months	37.5%
Employee Support Programs	56.1%	12 Months	18 Months	33.3%

Background Checks

We also asked survey respondents whether the victim organization ran a background check on the perpetrator before he or she was hired. The responses were fairly evenly split, with approximately 51% of organizations having conducted background checks and about 49% not having done so.

More than 88% of the background checks conducted did not reveal any prior misconduct or red flags, which underscores our findings that the majority of perpetrators are not career criminals—that is, they are usually first-time offenders (see Figure 92 on page 66 and Figure 93 on page 67) and typically do not take a job with the intention to defraud their employer. However, roughly 11% of the background checks conducted did uncover at least one red flag (e.g., prior criminal activity, employment issues, or financial problems) regarding the perpetrator—meaning that the organizations who hired these individuals knew or should have known about potential issues but hired the person anyway.

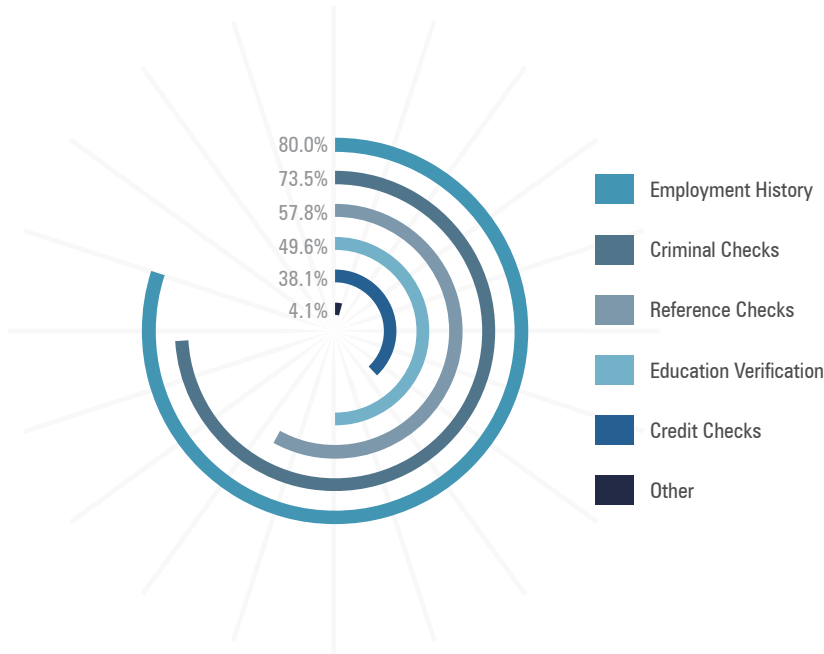
Figure 61: Background Check Run on Perpetrator Before Being Hired



Victim Organizations

Of the background checks that were run, most included checks of the perpetrators' employment and criminal history (80% and 73.5%, respectively). Additionally, more than half (57.8%) included a check of the future perpetrators' references, and nearly 50% involved an education verification.

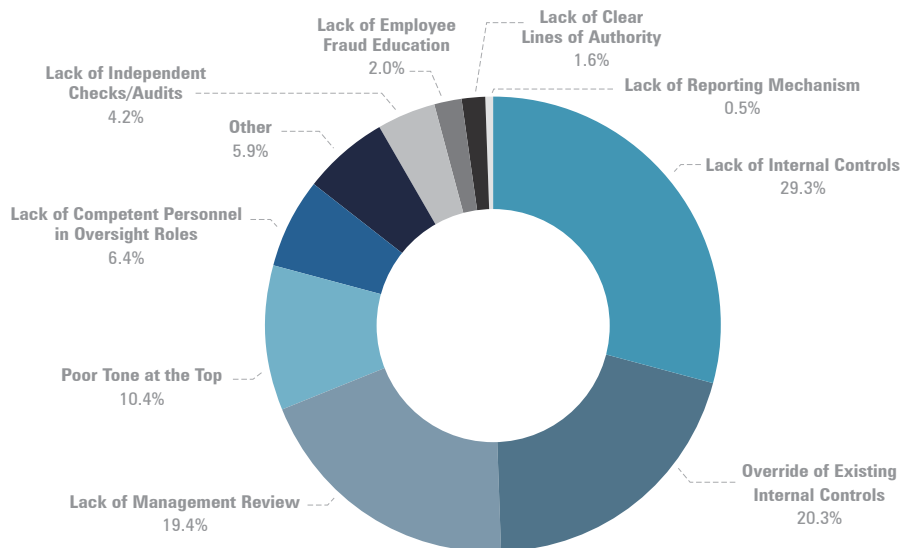
Figure 62: Type(s) of Background Checks Run on Perpetrator Before Being Hired



Internal Control Weaknesses That Contributed to Fraud

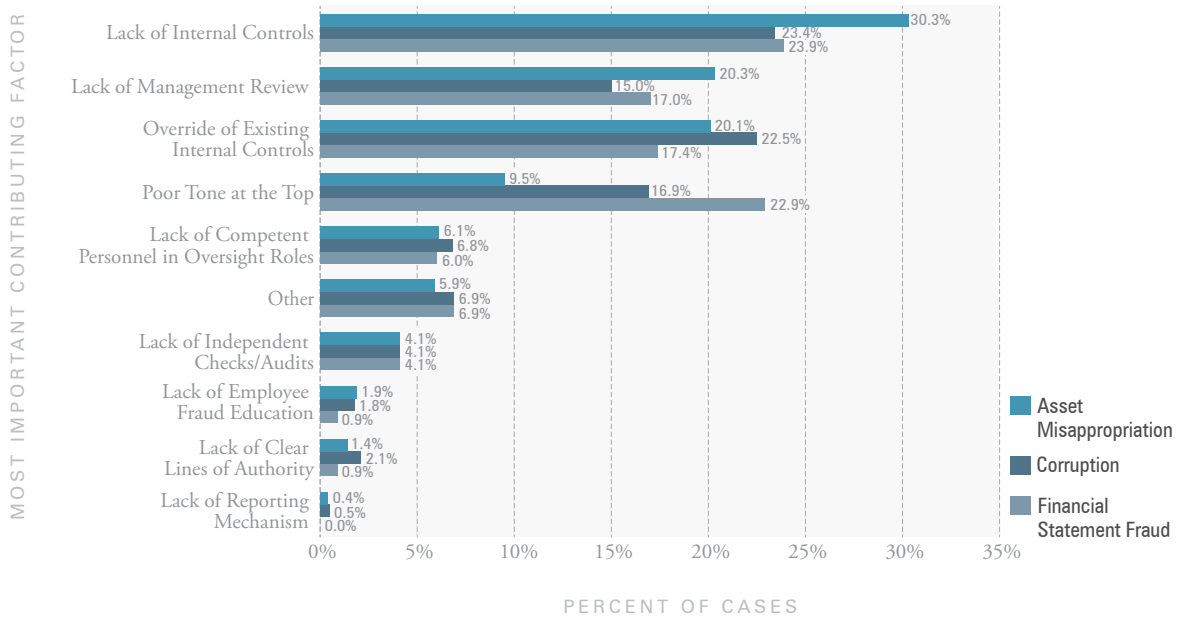
Even in hindsight it can be difficult to pinpoint the exact system breakdowns that allowed a fraud to occur. However, learning from past incidents of fraud is necessary to better prevent and detect fraud schemes in the future. Consequently, we asked survey respondents for their perspective on the internal control weaknesses at the victim organization that contributed to the fraudster's ability to perpetrate the scheme. Their responses are shown in Figure 63. More than 29% cited a clear lack of internal controls as the primary issue, with another 20.3% stating that internal controls were present but had been overridden by the perpetrator.

Figure 63: Primary Internal Control Weakness Observed by CFE



We also wanted to see whether the internal control weaknesses varied by the type of fraud scheme perpetrated. Our findings, shown in Figure 64, are interesting, if not surprising. Organizations that lacked internal controls were more susceptible to asset misappropriation schemes, while corruption schemes more often involved an override of existing controls. Further, a poor tone at the top was much more likely to contribute to a financial statement fraud scheme than either of the other two categories of occupational fraud.

Figure 64: Primary Internal Control Weakness by Scheme Type



CONTROL WEAKNESSES IN ORGANIZATIONS OFTEN DIRECTLY CONTRIBUTE TO FRAUD.

TOP 3 CONTROL WEAKNESSES THAT CONTRIBUTED TO FRAUD

- 29%** LACK OF INTERNAL CONTROLS
- 20%** OVERRIDE OF EXISTING INTERNAL CONTROLS
- 19%** LACK OF MANAGEMENT REVIEW

Perpetrators



We asked participants to provide information about the fraudsters they investigated, including factors related to the perpetrator's employment (level of authority, department, and tenure at the victim organization) and general demographic information (age, gender, and education level).¹⁰ We also compared cases with single perpetrators to those involving collusion among two or more people. Finally, we asked respondents to tell us about various behavioral red flags and prior misconduct that might have been warning signs of fraudulent conduct.

¹⁰ In cases where more than one fraudster was involved, the data on perpetrators relates to the *principal perpetrator*, which we defined as the person who worked for the victim organization and who was the primary culprit.

Perpetrator's Position

Since the first edition of the report in 1996, the perpetrator's level of authority has been strongly correlated with the size of the fraud, and that was true again in our 2016 data. Only 18.9% of frauds in our current study were committed by owners/executives, but the median loss in these cases was \$703,000. Employees and managers were much more likely to commit occupational fraud, but as Figure 65 shows, the losses in these schemes were much lower—though still substantial. The correlation between authority and loss most likely occurs because high-level fraudsters tend to have greater access to their organizations' assets than lower-level employees, as well as a better ability to evade or override anti-fraud controls.

Figure 65: Position of Perpetrator—Frequency and Median Loss

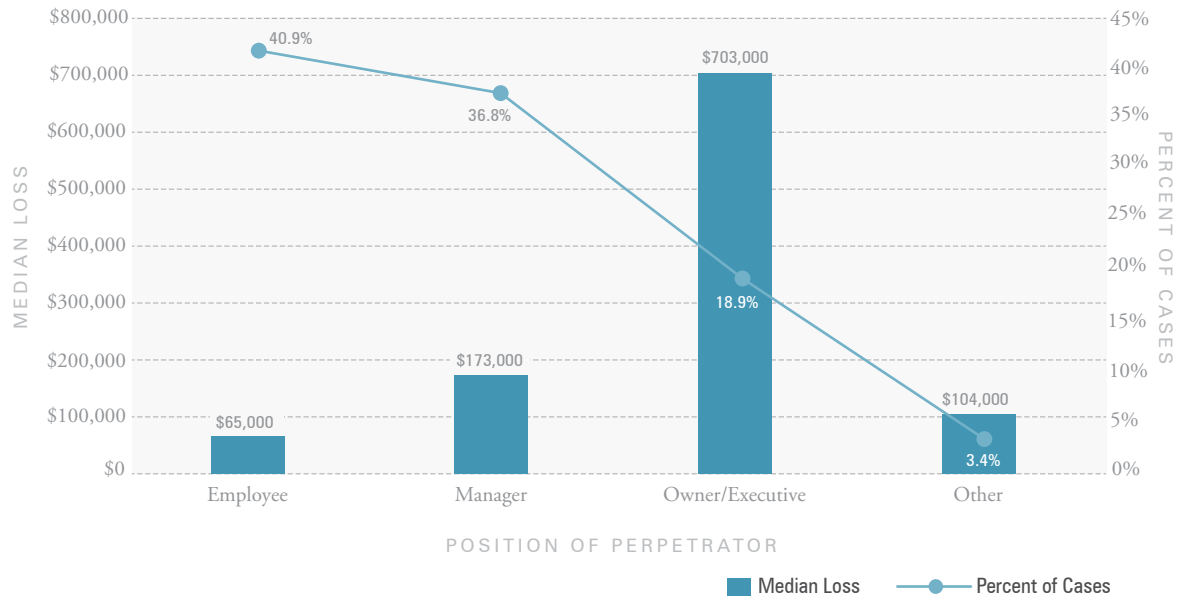


Figure 66 shows a correlation between the fraudster’s level of authority and the duration of the occupational fraud scheme. Because high-level fraudsters are generally better equipped to override or circumvent anti-fraud controls, we would expect their schemes to be harder to detect, and thus to last longer. The typical fraud committed by an employee in our study lasted one year before it was detected, whereas the typical fraud committed by an owner/executive lasted twice as long. Frauds committed by managers had a median duration of 18 months.

Figure 66: Median Duration of Fraud Based on Position

Position	Median Months to Detect
Employee	12
Manager	18
Owner/Executive	24
Other	18

Perpetrators

Position of Perpetrator Based on Region

Figures 67–75 show the frequency and median loss of occupational fraud schemes sorted by perpetrator position in each geographical region of our study. Generally speaking, this data follows the trend from the global dataset; in every region, losses rose along with authority.

Figure 67: Frequency and Median Loss Based on Position of Perpetrator—United States

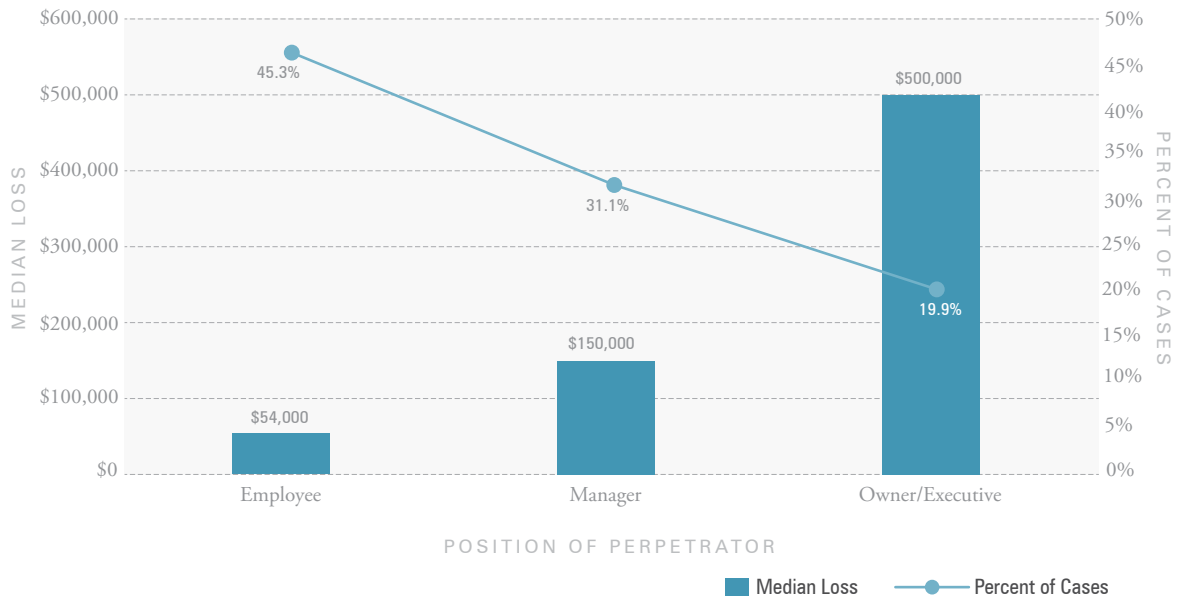


Figure 68: Frequency and Median Loss Based on Position of Perpetrator—Sub-Saharan Africa

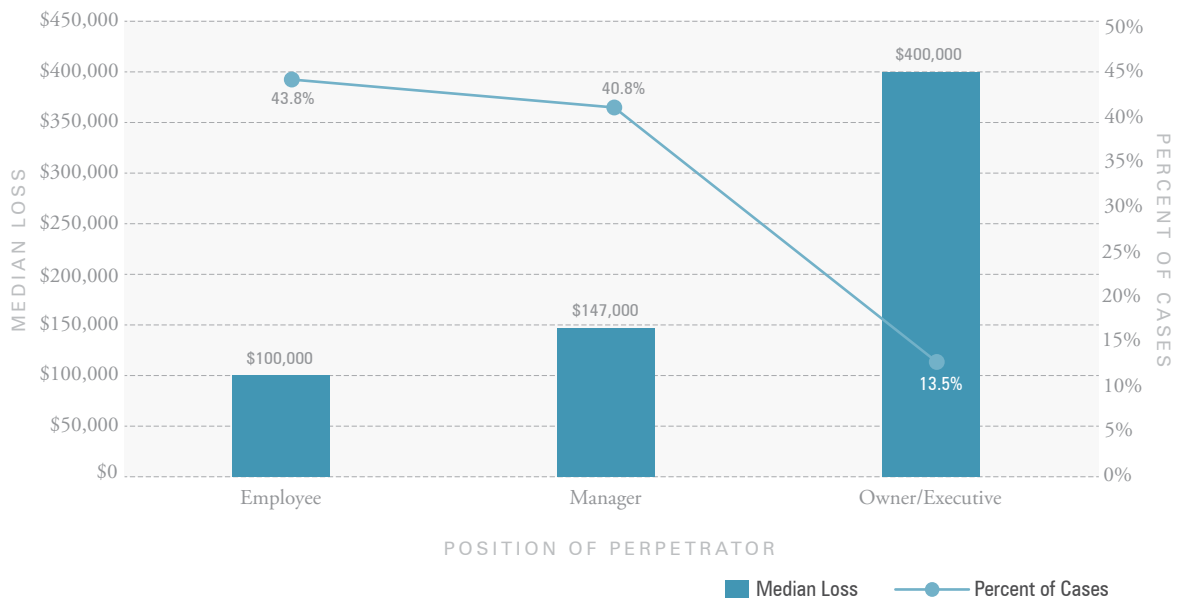


Figure 69: Frequency and Median Loss Based on Position of Perpetrator—Asia-Pacific

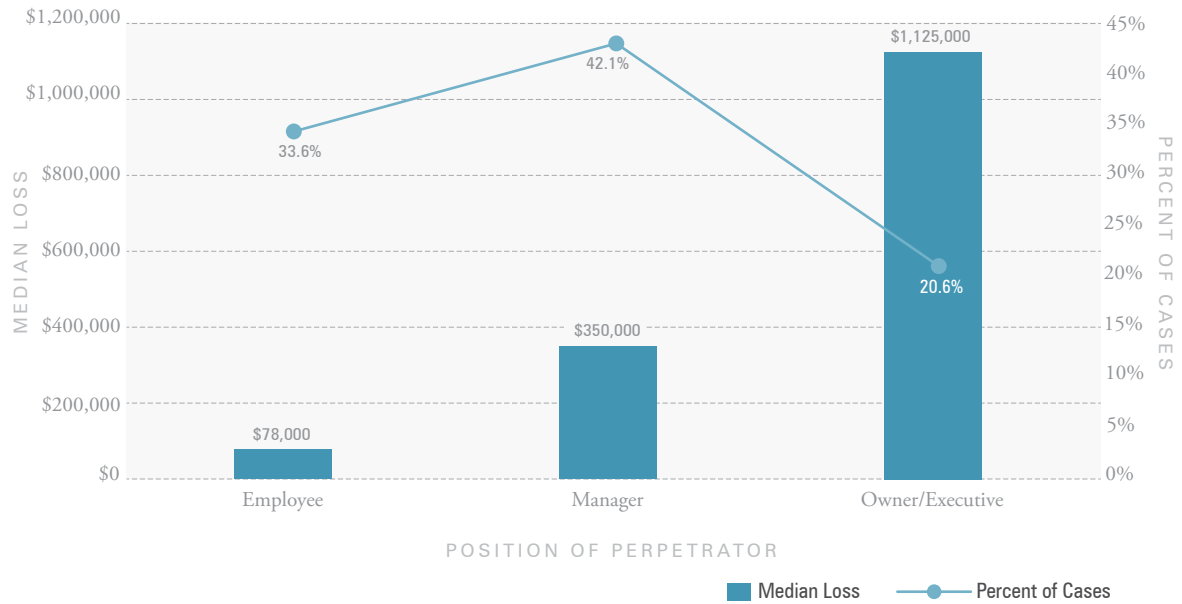
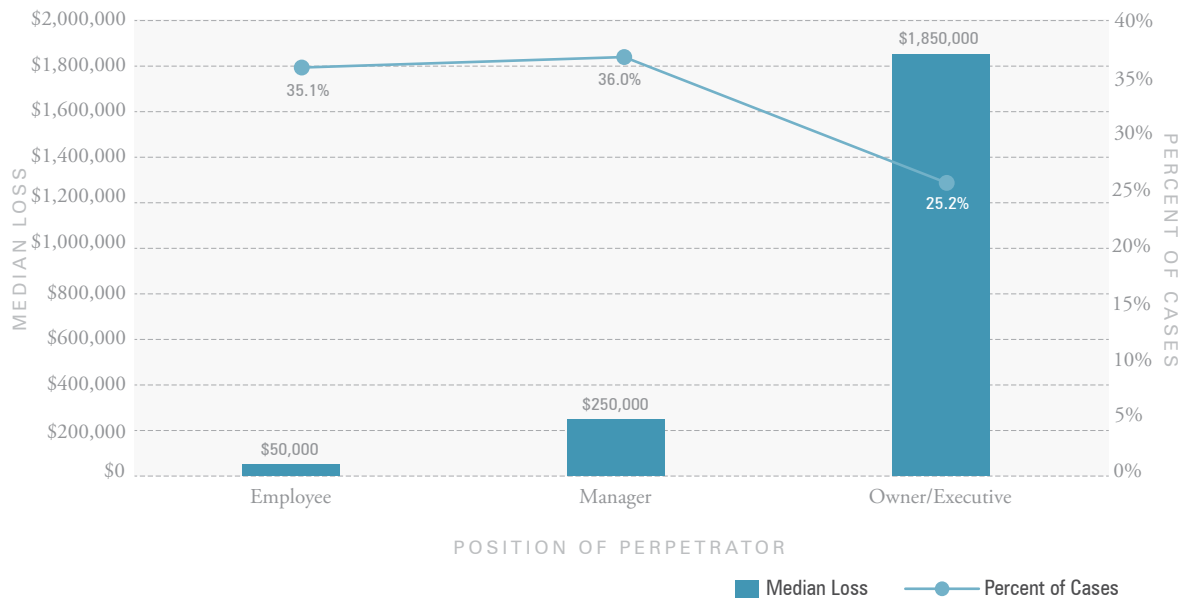


Figure 70: Frequency and Median Loss Based on Position of Perpetrator—Latin America and the Caribbean



Perpetrators

Figure 71: Frequency and Median Loss Based on Position of Perpetrator—Western Europe

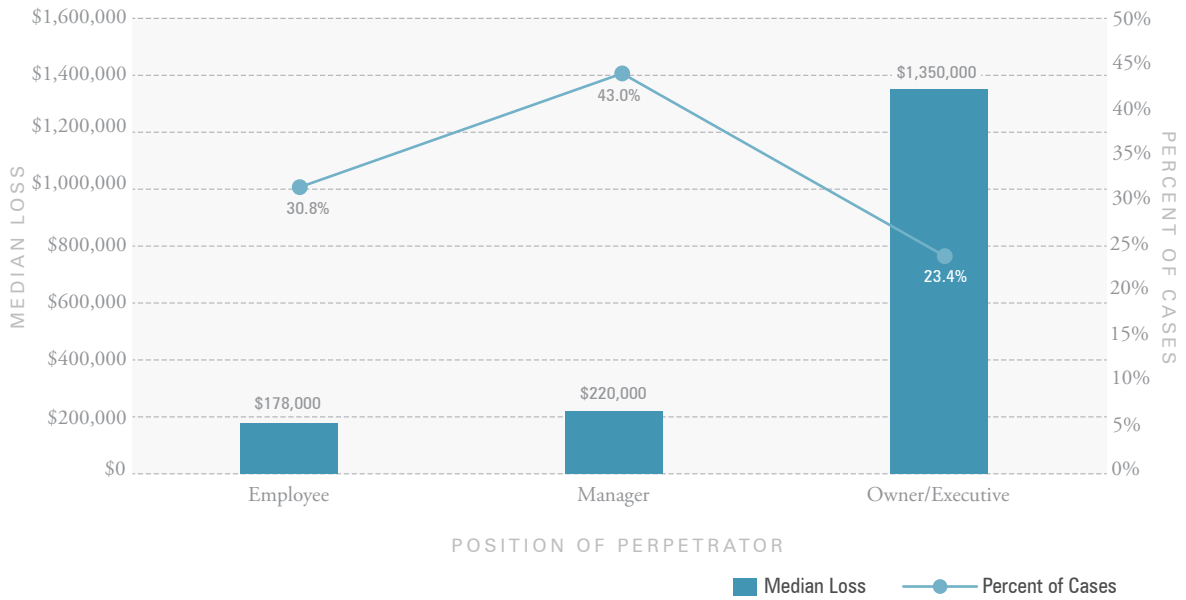


Figure 72: Frequency and Median Loss Based on Position of Perpetrator—Eastern Europe and Western/Central Asia

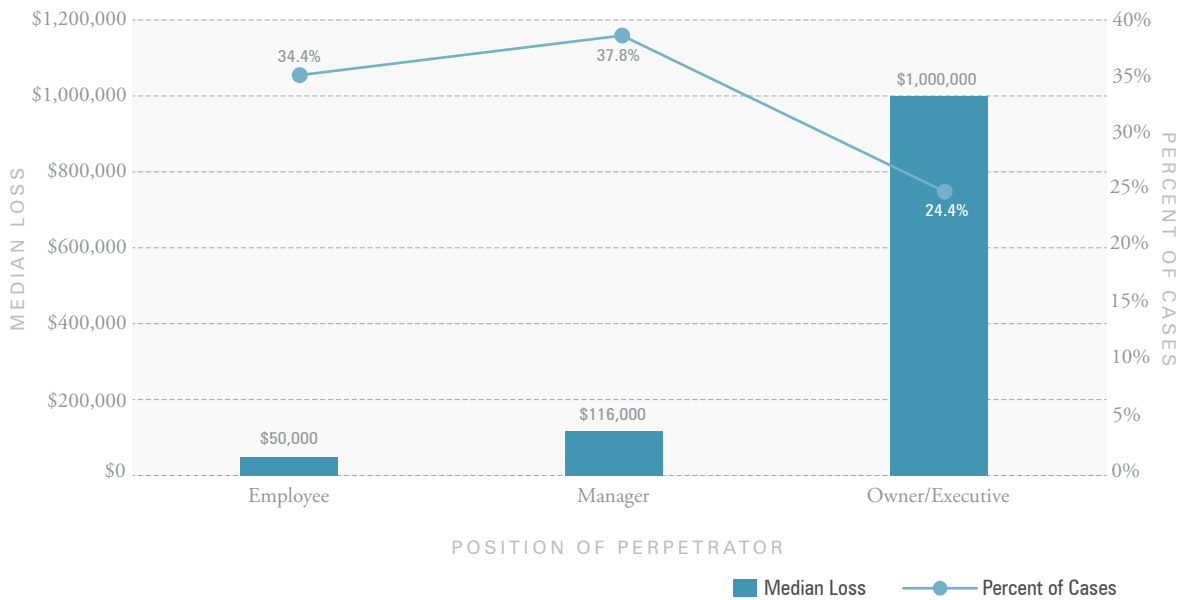


Figure 73: Frequency and Median Loss Based on Position of Perpetrator—Southern Asia

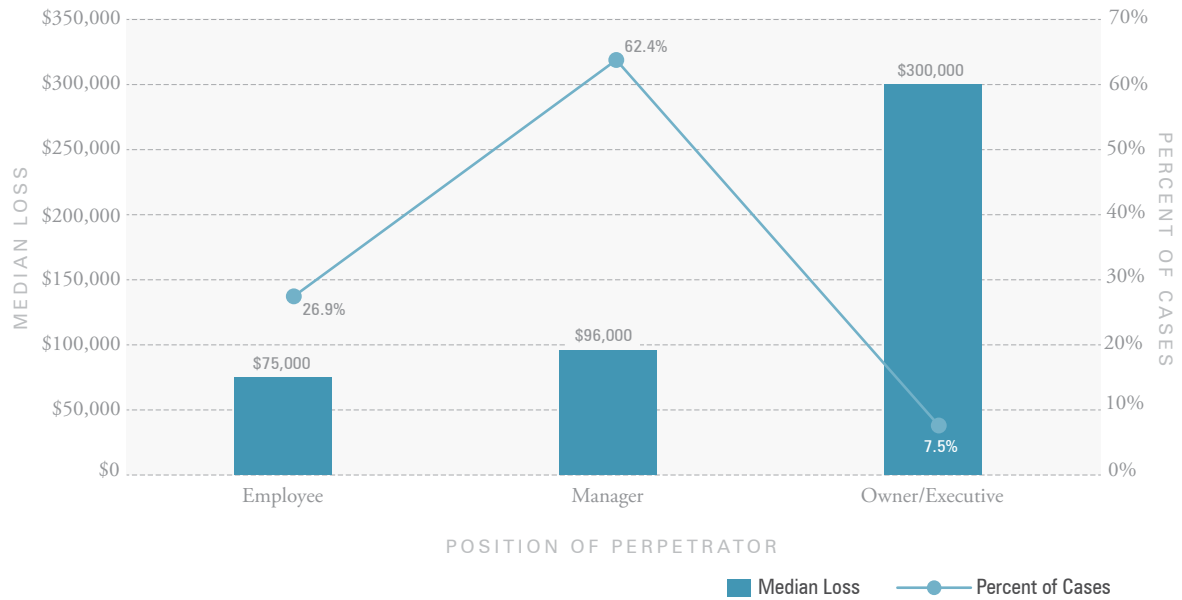
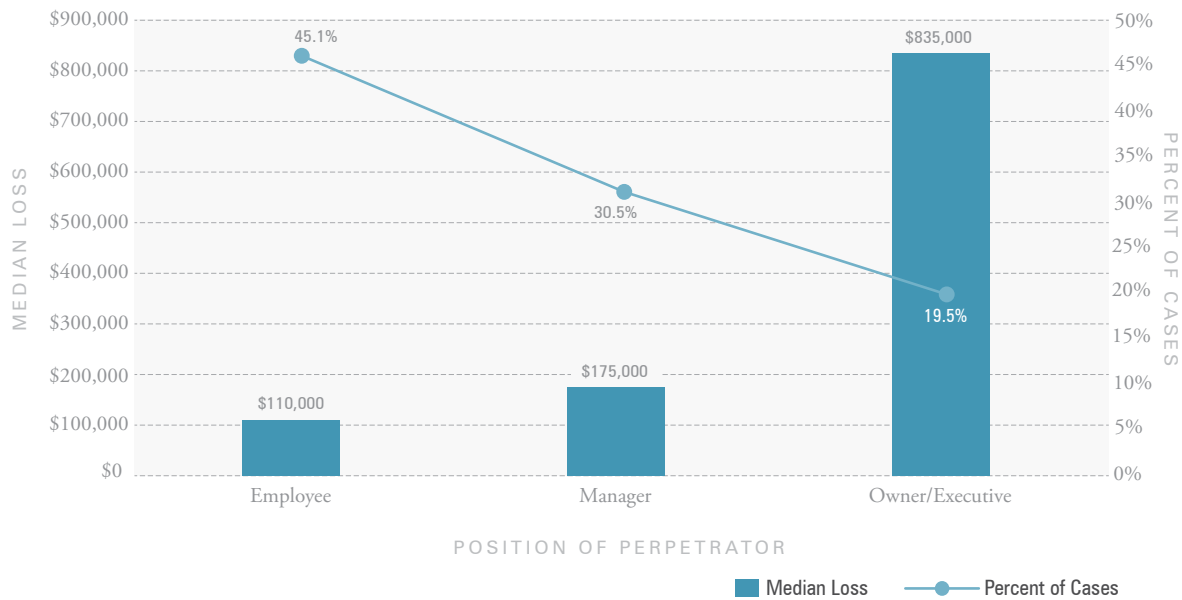
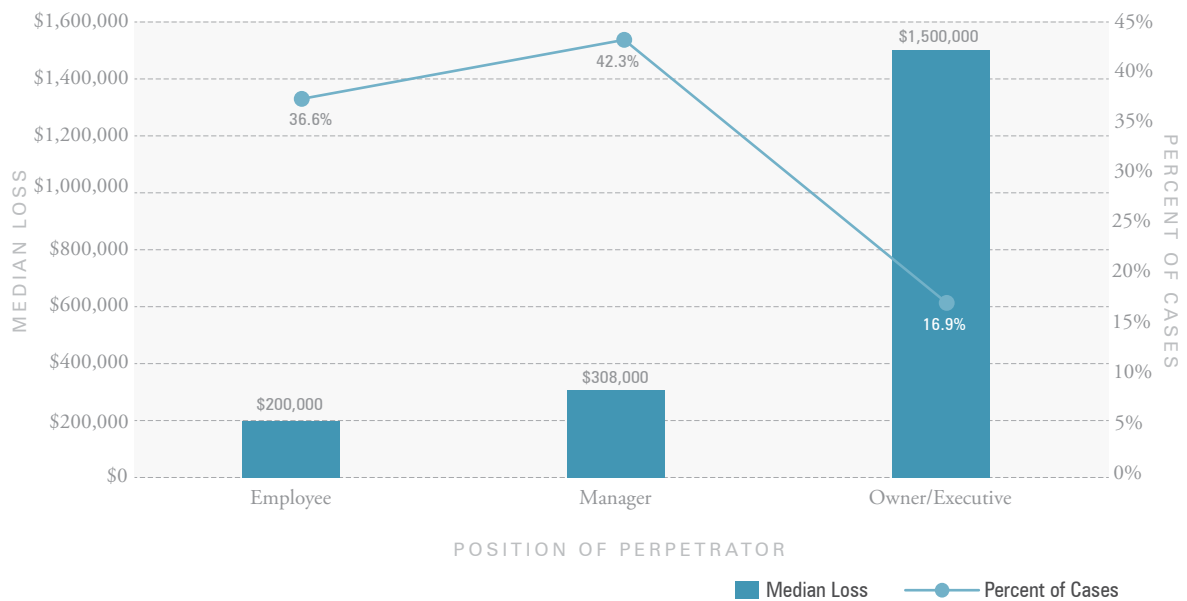


Figure 74: Frequency and Median Loss Based on Position of Perpetrator—Canada



Perpetrators

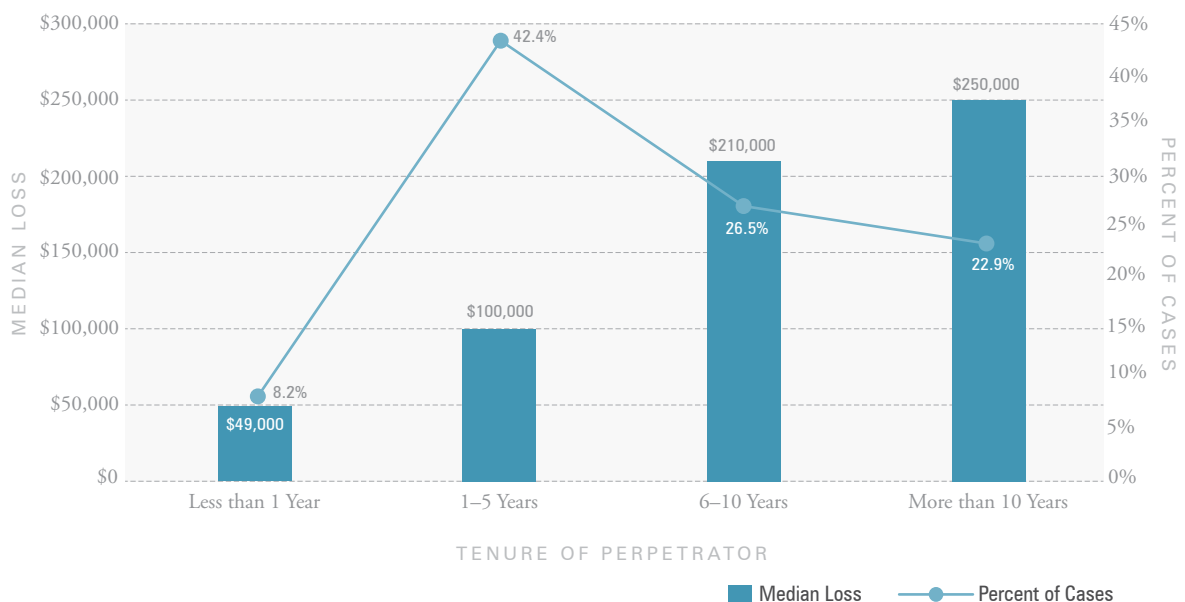
Figure 75: Frequency and Median Loss Based on Position of Perpetrator—Middle East and North Africa



Perpetrator's Tenure

In addition to the correlation between fraud losses and the fraudster's level of authority, fraud losses also tend to increase the longer a fraudster has worked for the victim organization, as shown in Figure 76. Perpetrators with between six and ten years' tenure caused a median loss of \$210,000, and those with more than ten years' tenure caused a median fraud loss of \$250,000. In cases where the fraudster had been employed by the victim for five years or fewer, losses were significantly lower. At least in part, this trend reflects the fraudster's position of authority. As shown in [Figure 65 on page 49](#), employees generally cause much smaller losses than managers or executives. Approximately one-half of the fraudsters with five or fewer years of tenure were classified as employees, whereas less than one-third of the fraudsters with six or more years of tenure were employees. In other words, people who stay at an organization for a long period of time often move up to higher levels of authority, which in turn gives them the opportunity to commit larger frauds.

Figure 76: Tenure of Perpetrator—Frequency and Median Loss

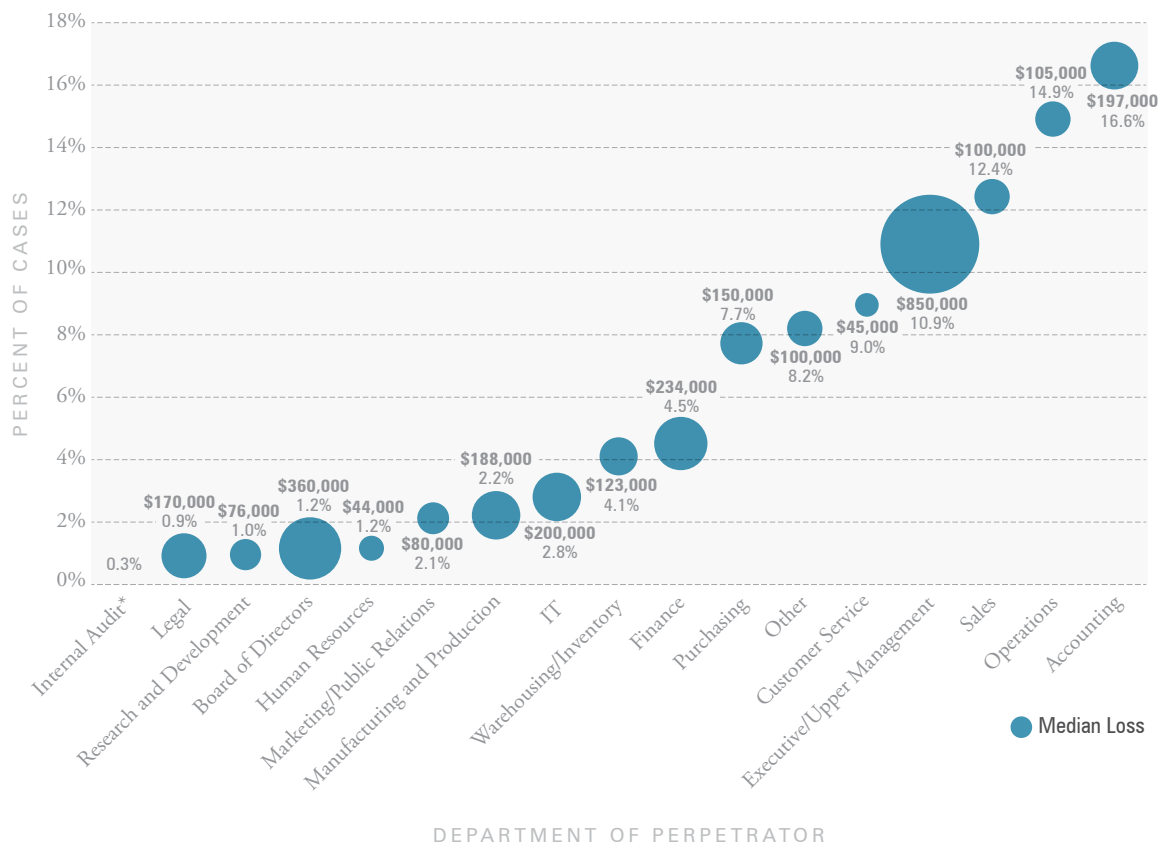


Perpetrator's Department

Figure 77 shows where fraudsters worked within the victim organizations in our study. The height of each bubble along the vertical axis represents the percentage of frauds that originated in each department, and the size of the bubble represents the median loss for those frauds. For example, we see that more frauds came from the accounting department (16.6%) than anywhere else and that the median loss in those cases (\$197,000) was slightly larger than the typical scheme. Fraudsters who worked as executives or upper management, conversely, caused much larger losses than anyone else (\$850,000) and accounted for about 11% of all cases.

Overall, a little more than three-fourths (76%) of occupational frauds came from seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing, and finance.

Figure 77: Department of Perpetrator—Frequency and Median Loss



*Internal Audit category had insufficient responses for median loss calculation.

Perpetrators

Schemes Based on Perpetrator's Department

Figure 78 shows how frequently various types of occupational fraud were committed within different departments. We analyzed all departments that had at least 75 reported cases to show what types of fraud might present the greatest risk within different areas of a typical organization. Boxes are shaded based on the respective level of occurrence, with red boxes indicating extremely high-frequency risks and light yellow denoting the least common schemes. Corruption accounted for at least 20% of cases in every department, but was a particularly high risk in purchasing (68.9% of cases) and executive/upper management (50.9%). Billing schemes rated as a significant risk in five departments, including executive/upper management, where they accounted for 36.8% of cases. This data may be helpful in developing effective risk-based anti-fraud controls that are tailored to specific departments or functions within an organization.

Figure 78: Frequency of Schemes Based on Perpetrator's Department

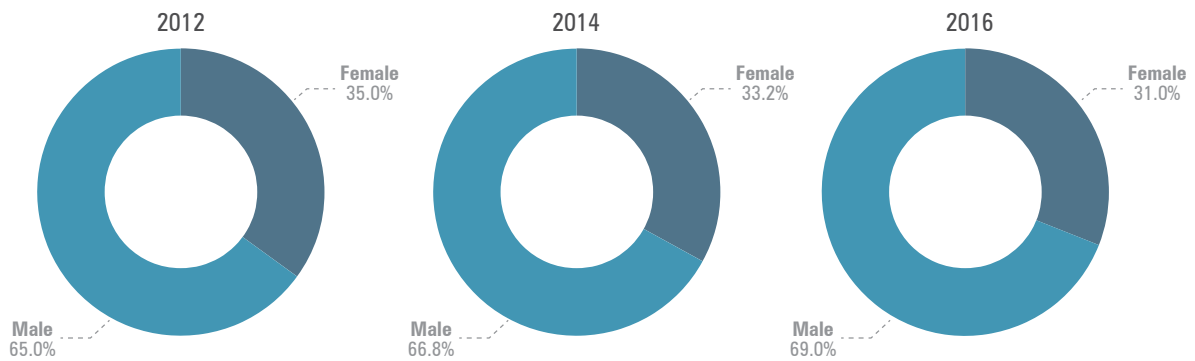
Department/ Scheme	Accounting	Operations	Sales	Executive/Upper Management	Customer Service	Purchasing	Finance	Warehousing/ Inventory
Cases	348	312	260	228	189	161	94	86
Billing	27.0%	21.5%	14.2%	36.8%	9.5%	25.5%	24.5%	9.3%
Cash Larceny	14.9%	7.7%	8.1%	10.1%	14.3%	3.7%	18.1%	0.0%
Cash on Hand	15.5%	13.8%	6.5%	12.3%	18.5%	13.0%	22.3%	5.8%
Check Tampering	30.5%	9.3%	2.7%	13.6%	7.4%	6.2%	24.5%	1.2%
Corruption	21.6%	34.9%	34.6%	50.9%	25.4%	68.9%	37.2%	32.6%
Expense Reimbursements	15.8%	12.2%	14.2%	23.7%	5.8%	14.9%	14.9%	3.5%
Financial Statement Fraud	12.9%	5.4%	7.3%	30.3%	3.7%	3.1%	23.4%	9.3%
Non-Cash	7.2%	19.6%	20.4%	24.6%	16.4%	18.6%	13.8%	67.0%
Payroll	21.6%	6.4%	1.5%	10.1%	3.7%	5.0%	7.4%	2.3%
Register Disbursements	3.2%	4.2%	5.0%	1.8%	3.2%	4.3%	3.2%	0.0%
Skimming	17.5%	12.8%	11.9%	11.8%	16.9%	7.5%	12.8%	5.8%



Perpetrator’s Gender

Among the cases in our 2016 study, 69% of fraud perpetrators were male and 31% were female. This is consistent with gender distributions we have encountered in past studies; females have been responsible for between 30% and 35% of frauds in every study since we began collecting global data (see Figure 79). To some extent, this probably reflects the labor force itself. Men make up a larger portion of the global workforce than women, so we might expect them to commit a larger portion of occupational frauds.¹¹ However, workforce participation does not account for all the gender differences in occupational fraud. Our study also explored how the perpetrator’s gender correlates with differences in loss, scheme type, and behavioral indicators of fraud (see pages 58–59 and 71).

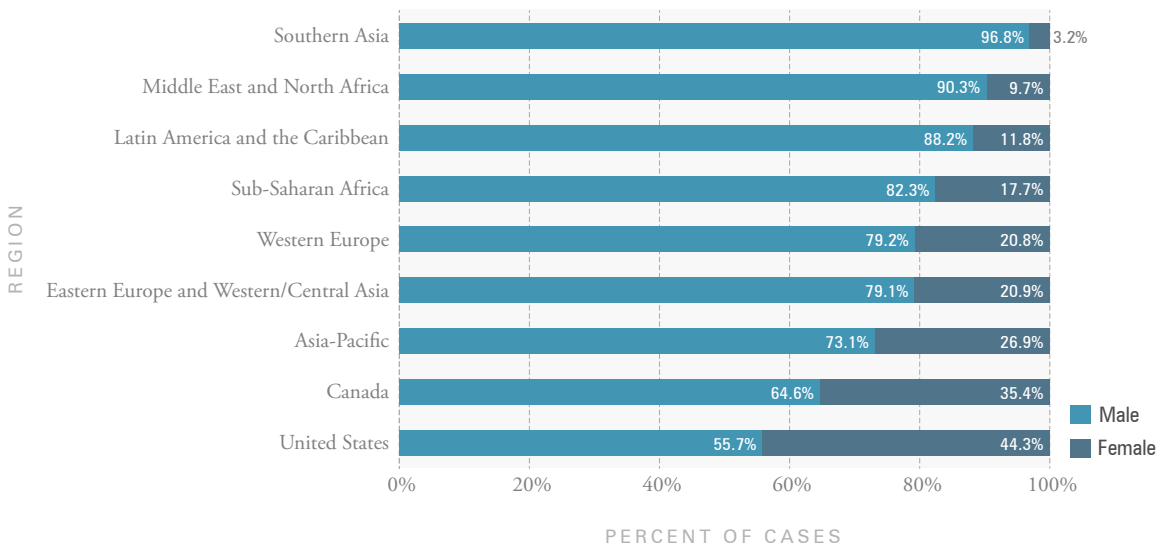
Figure 79: Gender of Perpetrator—Frequency



Perpetrator’s Gender Based on Region

Figure 80 shows the gender distribution of fraud perpetrators based on the region in which the fraud occurred. The largest imbalance was in Southern Asia, where nearly 97% of fraudsters were male, while the United States had the most even distribution between males and females: men accounted for 55.7% of frauds, and women were responsible for 44.3%.

Figure 80: Gender of Perpetrator Based on Region



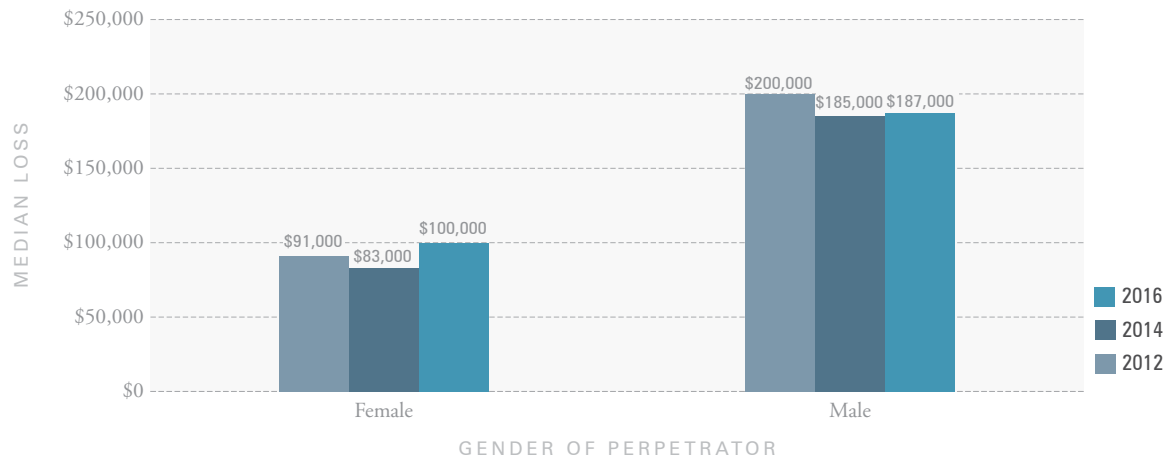
¹¹ A 2013 report by the World Bank estimated that females make up 40% of the global labor force. The World Bank, *Gender at Work: A Companion to the World Development Report on Jobs* (www.worldbank.org/content/dam/Worldbank/Event/Gender/GenderAtWork_web2.pdf)

Perpetrators

Median Loss Based on Gender

Males not only are responsible for a larger number of frauds than females, but they also generally cause larger losses. In our 2016 data, the median loss caused by a male fraudster was \$187,000, while the median loss caused by a female was \$100,000. As Figure 81 shows, we have consistently seen a large gap between male and female median fraud losses.

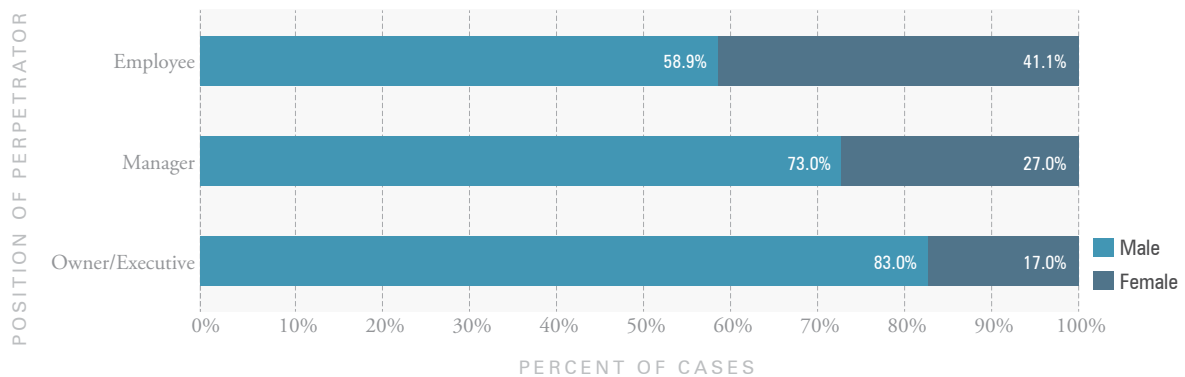
Figure 81: Gender of Perpetrator—Median Loss



Position of Perpetrator Based on Gender

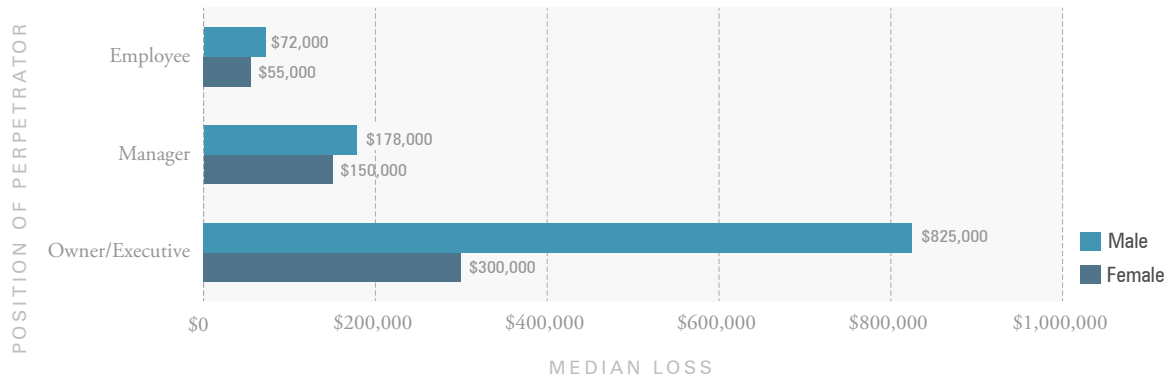
One possible explanation for the gender disparity in fraud losses could be related to position of authority. As shown in Figure 65 on page 49, higher levels of authority are correlated with larger fraud losses (e.g., owner/executives tend to commit larger frauds than managers, and managers tend to commit larger frauds than employees). As Figure 82 shows, the proportion of male fraudsters increases as we move up the organizational chart. Only 58.9% of employee-level fraudsters were male, but that figure rose to 73% among managers and 83% among owner/executives. Given this distribution, we would expect the median fraud loss for males to be quite a bit higher than for females.

Figure 82: Position of Perpetrator Based on Gender



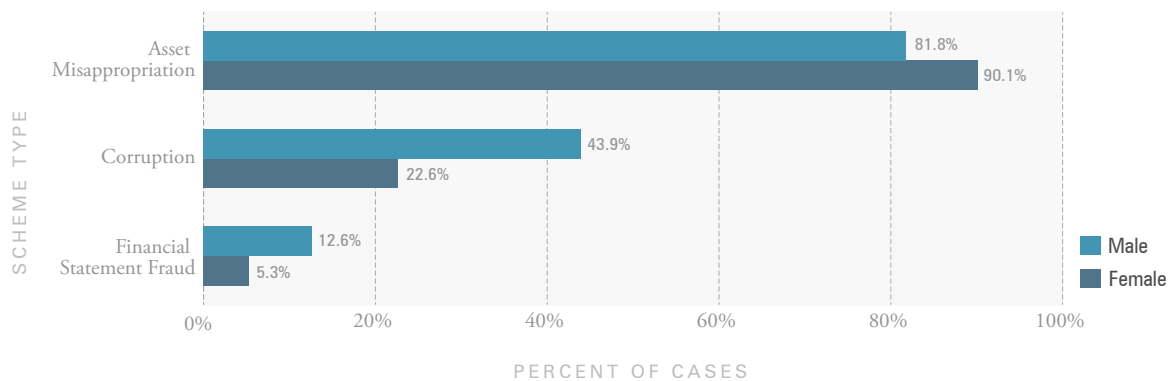
But interestingly, when we break this analysis down further to compare losses at each level of authority, males still tend to cause significantly higher losses than females (see Figure 83). At the employee level, the median loss for a male fraudster was \$72,000 versus \$55,000 for a female; this represents a 30.9% increase. At the manager level, frauds committed by men were 18.6% larger than those committed by females, and at the owner/executive level, frauds by men were 175% larger. This is comparable to our findings in 2014 and 2012.

Figure 83: Position of Perpetrator—Median Loss Based on Gender



In addition to differences in frequency and loss, our data also indicates a discrepancy in the types of fraud committed by males and females. According to Figure 84, 43.9% of male perpetrators committed corruption and 12.6% committed financial statement fraud. Conversely, only 22.6% of female perpetrators committed corruption and only 5.3% committed financial statement fraud. Corruption and financial statement fraud tend to cause much higher losses than asset misappropriation (see Figure 5 on page 12), so this discrepancy in the type of fraud committed might also help explain why frauds committed by males tend to be much larger.

Figure 84: Frequency of Schemes Based on Gender

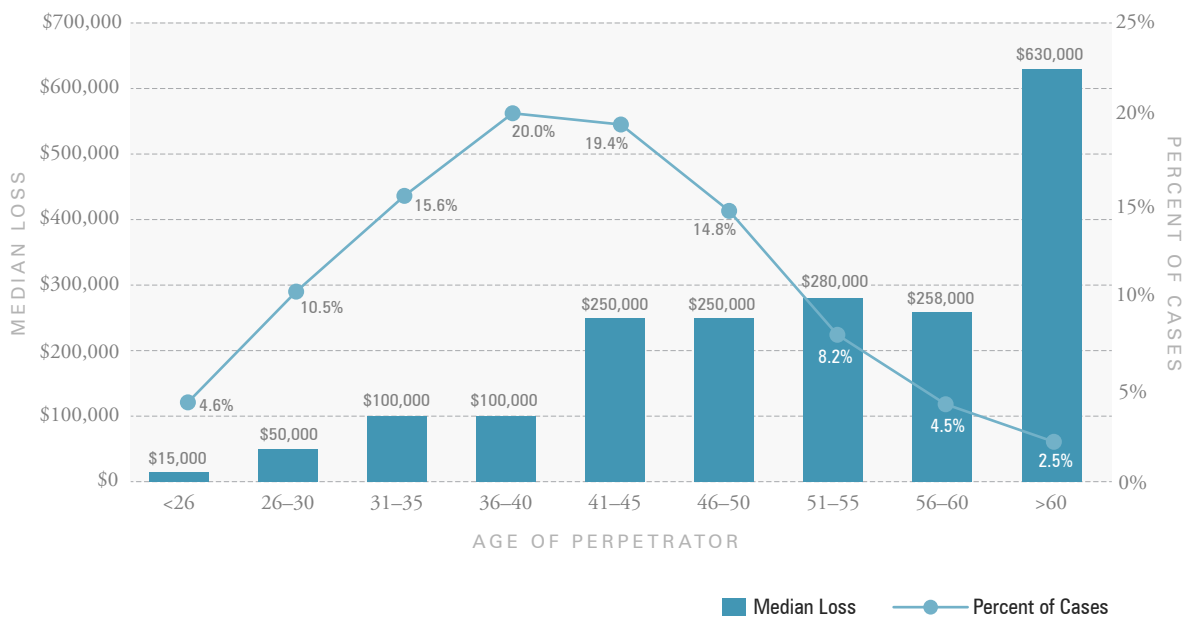


Perpetrators

Perpetrator's Age

Figure 85 presents the frequency and median loss of fraud schemes based on the perpetrator's age. The frequency distribution shows that 55% of fraudsters were between the ages of 31 and 45. Losses, however, generally rose with the age of the fraudster. Fewer than 3% of frauds were committed by people over the age of 60, but these cases had a median loss of \$630,000, which was much higher than any other age range. Also, our data showed a line of demarcation right around the age of 40. In all ranges at or below the age of 40, the highest median loss was \$100,000. In all ranges above the age of 40, the median loss was \$250,000 or higher.

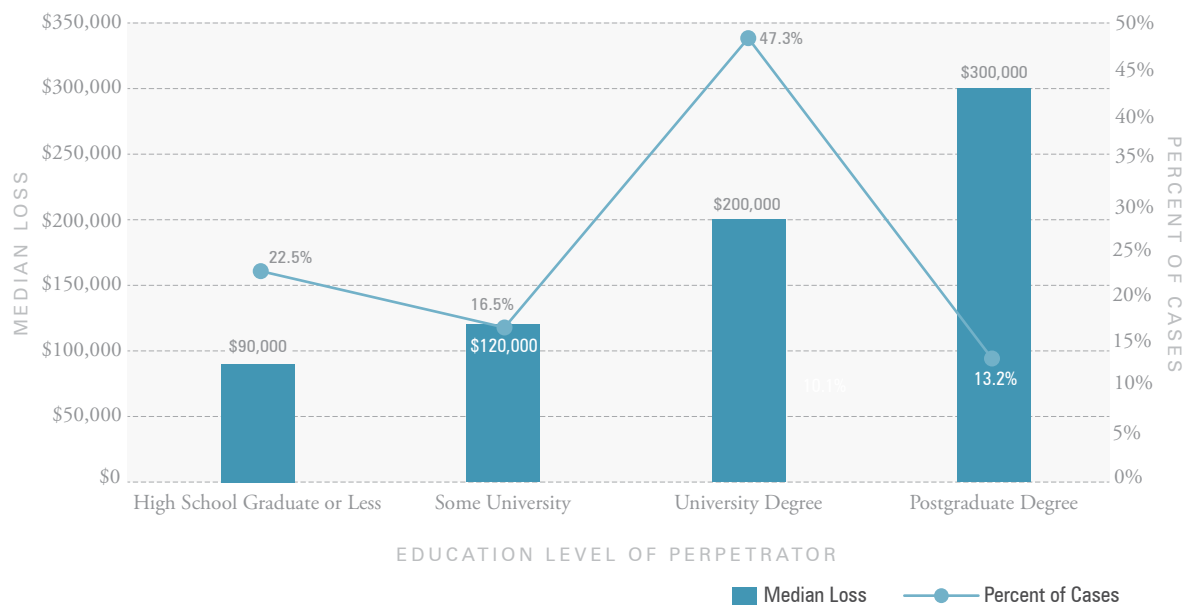
Figure 85: Age of Perpetrator—Frequency and Median Loss



Perpetrator’s Education Level

Losses also tend to correlate with education, as shown in Figure 86. Fraud perpetrators with a university degree caused a median loss of \$200,000, and those with a postgraduate degree caused a median loss of \$300,000. These figures were significantly higher than the losses caused by less educated fraudsters. This discrepancy might be another factor that is heavily influenced by the fraudster’s position of authority. More than 70% of those with university or postgraduate degrees in our study were either managers or owner/executives, while those without a university degree were much more likely to have lower-level jobs.

Figure 86: Education Level of Perpetrator—Frequency and Median Loss

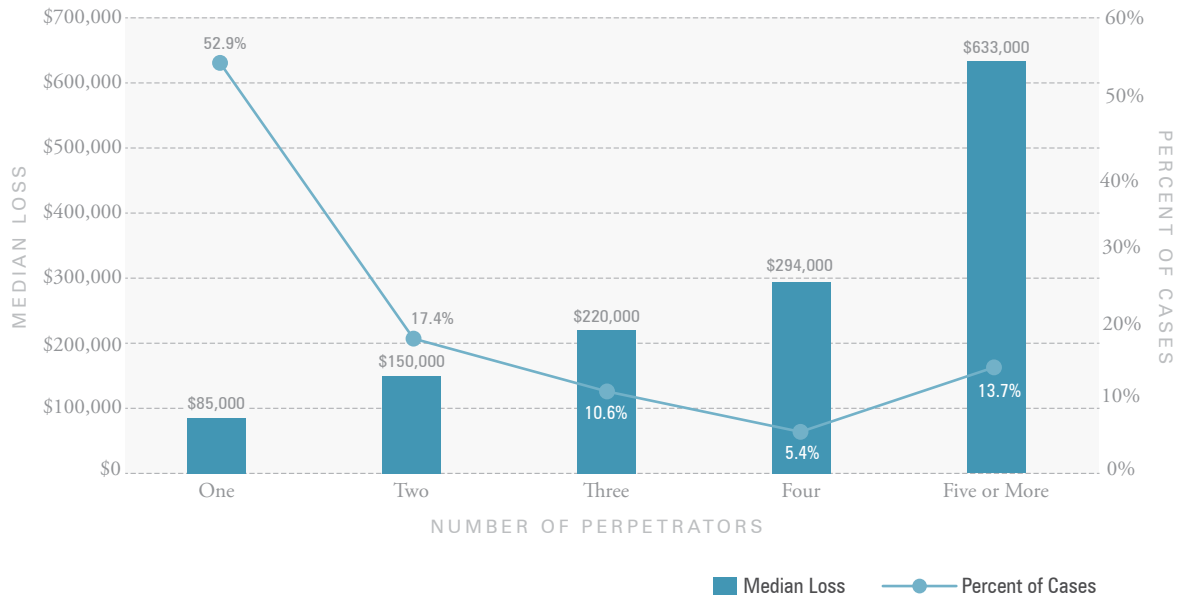


Perpetrators

The Impact of Collusion

Nearly half of the cases in our study involved multiple perpetrators colluding with one another to commit fraud, and the greater the number of fraudsters involved, the higher losses tended to be (see Figure 87).

Figure 87: Number of Perpetrators—Frequency and Median Loss



One possible reason for the increase in losses associated with multiple perpetrators is that many anti-fraud controls work on the basis of separation of duties and independent checks. When multiple fraudsters work together, they might be able to undermine the process of independently verifying transactions or other mechanisms designed to uncover fraud. However, when we looked at the duration of frauds (see Figure 88), we found that schemes with multiple perpetrators did not last significantly longer than single-perpetrator frauds, which was also true in our 2014 study. That would indicate that collusion schemes, while more costly, were not necessarily more difficult to detect.

Another explanation for the larger losses in schemes with multiple perpetrators could simply be that with more fraudsters involved, the perpetrators needed to steal more because their proceeds were being split more ways. In other words, with more perpetrators expecting a payout, the conspirators needed to steal more to satisfy everyone involved in the crime.

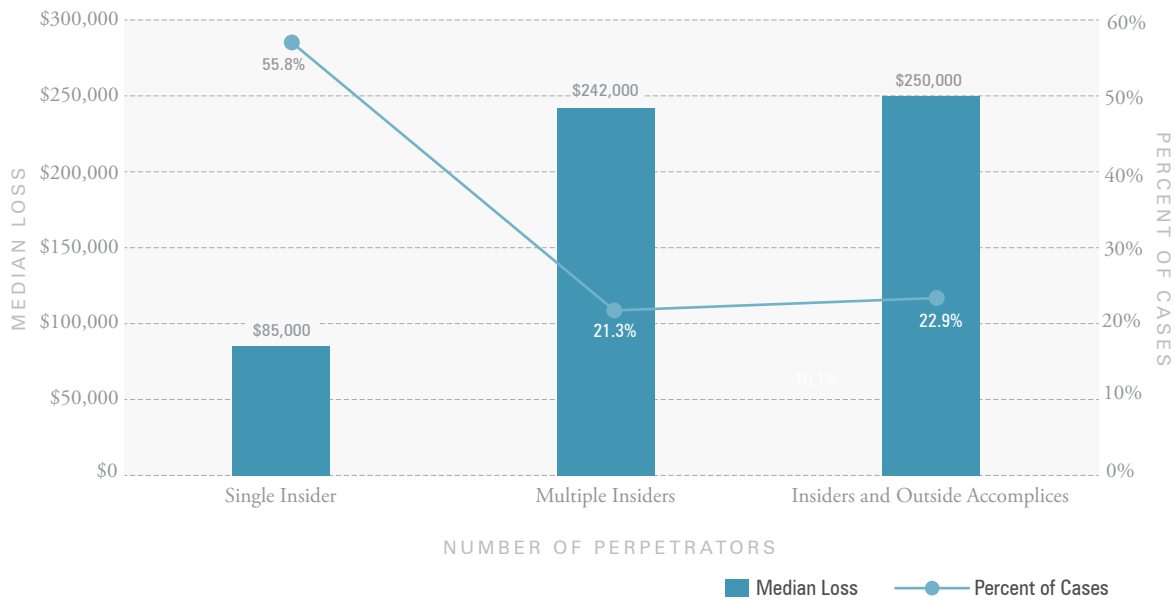
Figure 88: Median Duration of Fraud Based on Number of Perpetrators

Number	Median Months to Detect
One	16
Two or More	18

Collusion Based on Perpetrators' Relationship to Victim

Given the impact collusion appears to have on the size of occupational fraud, we wanted to see if this impact varied based on who was colluding. Specifically, we compared frauds in which all the perpetrators worked for the victim organization to frauds in which an insider conspired with an outside accomplice at one of the victim's customers or vendors. We wanted to see if it was more common for insiders to conspire with one another or to work with an outside party, and we also wanted to examine whether there were differences in the types of fraud committed or the size of the losses depending on the group involved. As Figure 89 shows, insider collusion and third-party collusion were practically identical both in terms of frequency and median loss.

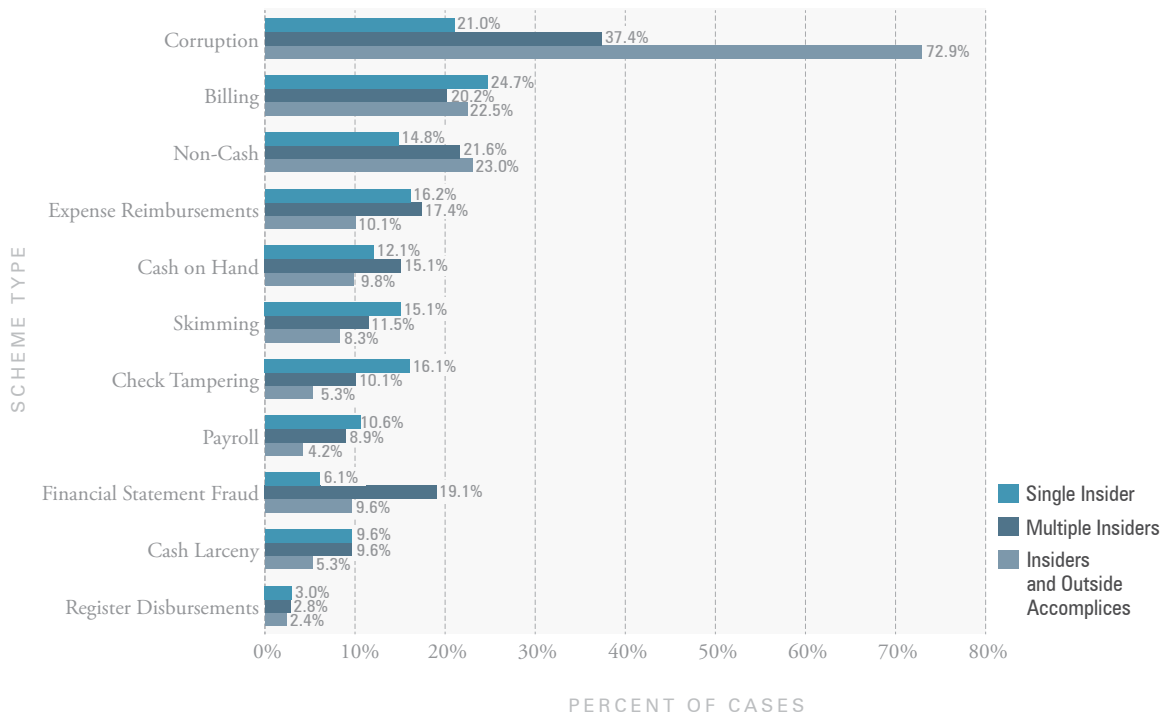
Figure 89: Collusion—Frequency and Median Loss Based on Perpetrators' Relationship to Victim



Perpetrators

However, when we compared the schemes that were committed based on the perpetrators' relationship to the victim, we did find some differences. Obviously, corruption schemes were most common when an insider colluded with a customer or vendor. We also found that financial statement fraud was much more likely to be committed by a group of insiders than by a single individual or with the help of a customer or vendor. Non-cash misappropriations were also more likely to be committed by multiple perpetrators than a lone individual.

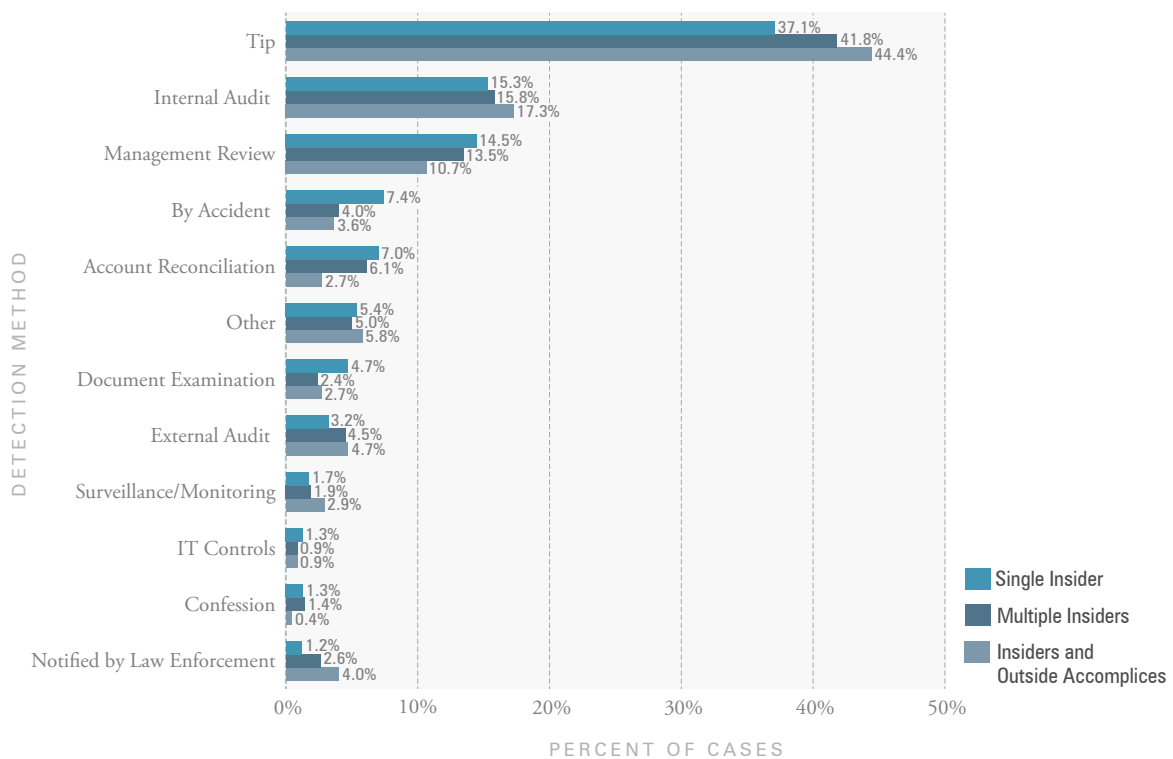
Figure 90: Scheme Type Based on Perpetrators' Relationship to Victim



Finally, we examined how frauds were detected based on the perpetrators' relationship to the victim. We expected to see noticeable differences in this data because the way a single perpetrator conceals occupational fraud should differ from the way a group of perpetrators conceal their crime. Generally speaking, a group of fraudsters would be in a much better position to override controls, falsify independent checks, or verify fraudulent transactions. Because of this, we expected that these schemes would tend to be detected by different means than frauds committed by individuals. With regard to outside accomplices, we would expect that collusion with a customer or vendor would produce different red flag indicators than other types of fraud, again leading to different forms of detection.

Our analysis did show some small differences in the way frauds were caught, based on the perpetrators' relationship to the victim, but generally speaking there was not a great deal of variation (see Figure 91). Frauds involving multiple perpetrators were more likely to be caught by a tip than single-perpetrator schemes. Conversely, a perpetrator acting alone was slightly more likely to be detected by standard internal controls (e.g., management review and account reconciliation) than multiple-perpetrator schemes. Otherwise, the means of detection did not appear to vary much regardless of who or how many perpetrators were involved in the fraud.

Figure 91: Detection Method by Perpetrators' Relationship to Victim



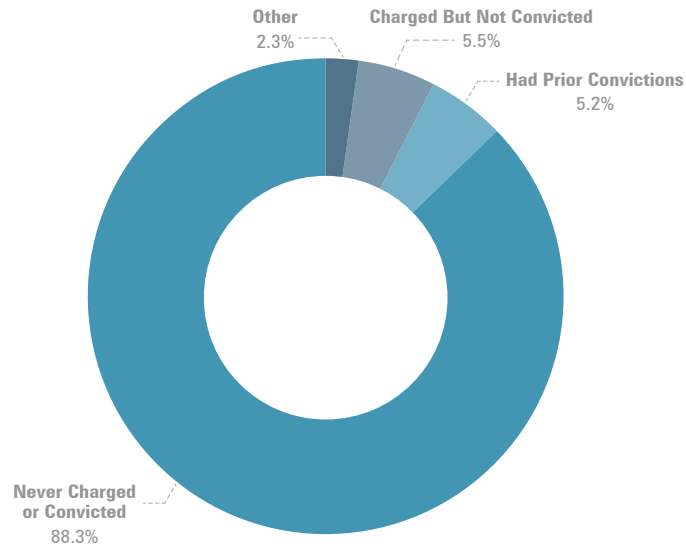
Perpetrators

Perpetrator's Criminal and Employment History

Perpetrator's Criminal Background

Only 5.2% of the fraudsters in our study had previously been convicted of a fraud-related offense (see Figure 92). This has been a consistent finding since our first report in 1996; the vast majority of occupational fraudsters have no history of fraud convictions.

Figure 92: Criminal Background of Perpetrator



THE VAST MAJORITY OF OCCUPATIONAL FRAUDSTERS ARE FIRST-TIME OFFENDERS.

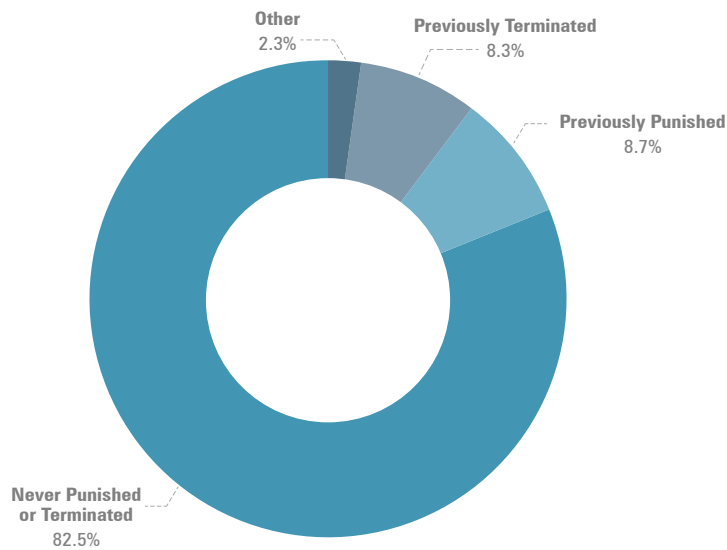
AMONG PERPETRATORS IN OUR STUDY, ONLY

- 5% WERE CONVICTED OF A PRIOR FRAUD-RELATED OFFENSE
- 8% WERE FIRED FOR FRAUD-RELATED CONDUCT BY A PREVIOUS EMPLOYER

Perpetrator’s Employment History

As shown in Figure 93, approximately 83% of occupational fraudsters had never been terminated or punished for any form of fraud-related conduct prior to the crimes in this study. Thus, in terms of both criminal and employment history, most people who commit occupational fraud are likely first-time offenders. Readers should note, however, that according to Figure 100 on page 75, about 40% of fraud cases in our study were never referred to law enforcement, and according to Figure 106 on page 78, a significant number of perpetrators either received no punishment from their employers, were permitted to resign, or entered into settlement agreements (which typically are confidential). Therefore, it is very likely that the actual number of perpetrators with a history of fraud-related conduct is higher than what can be identified through conviction reports and employment background records.

Figure 93: Employment Background of Perpetrator



Perpetrators

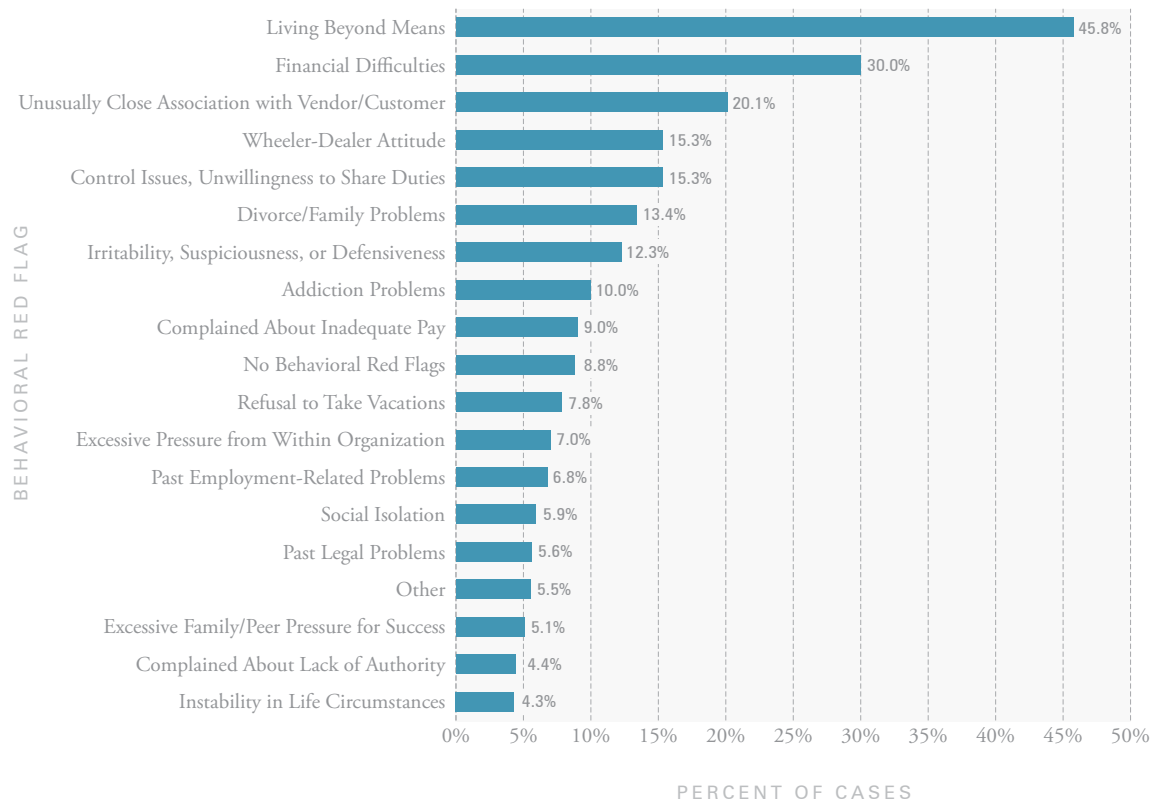
Behavioral Red Flags Displayed by Perpetrators

We presented survey respondents with a list of 17 common behavioral red flags associated with occupational fraud and asked them to tell us which, if any, of these warning signs had been displayed by the perpetrator before the fraud was detected. In more than 91% of cases, at least one behavioral red flag was identified prior to detection, and in 57% of cases two or more red flags were seen.

Figure 94 shows the frequency of behavioral red flags in our 2016 data. As that chart illustrates, the six most common behavioral red flags were: (1) living beyond means; (2) financial difficulties; (3) unusually close association with a vendor or customer; (4) a general “wheeler-dealer” attitude involving shrewd or unscrupulous behavior; (5) excessive control issues or unwillingness to share duties; and (6) recent divorce or family problems. Approximately 79% of the perpetrators in our study displayed at least one of these six red flags during their schemes.

What is even more notable is how consistent the distribution of red flags has been over time. The six most common red flags shown in Figure 94 have also been the six most common red flags in every report since 2008, when we first began tracking this data.

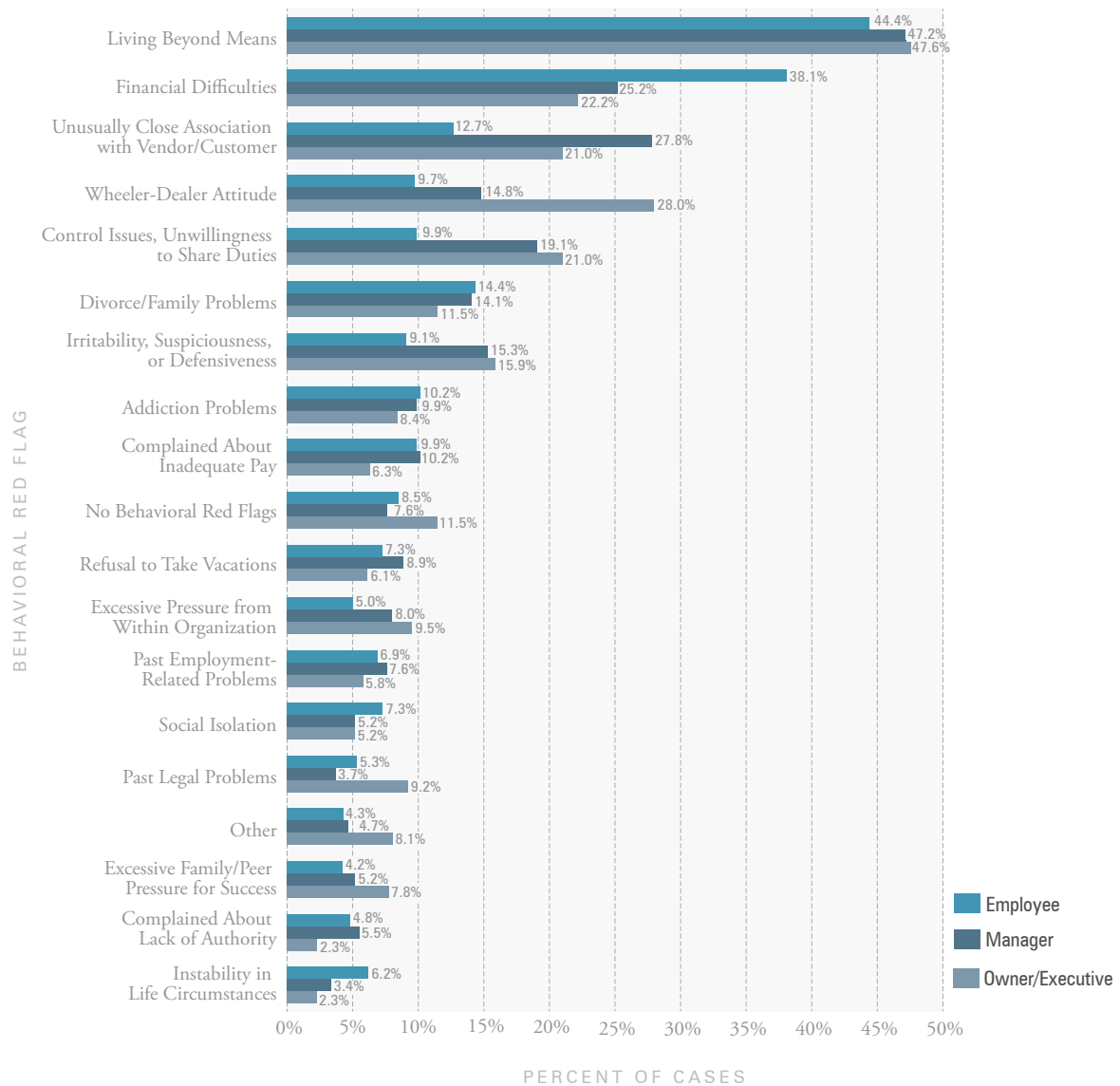
Figure 94: Behavioral Red Flags Displayed by Perpetrators



Behavioral Red Flags Based on Perpetrator’s Position

Figure 95 shows the distribution of behavioral red flags based on the perpetrator’s level of authority. The purpose of this chart is to show how individuals at different levels within an organization might have different motivations or rationalizations for committing fraud. For instance, approximately 38% of all employee fraudsters were undergoing financial difficulties at the time of their frauds, but this red flag was not nearly as common for higher-level perpetrators. Managers were much more likely than the other two groups to have an unusually close association with a vendor or customer, and fraudsters at the owner/executive level were significantly more likely to have a “wheeler-dealer” attitude involving shrewd or unscrupulous behavior.

Figure 95: Behavioral Red Flags Based on Perpetrator’s Position

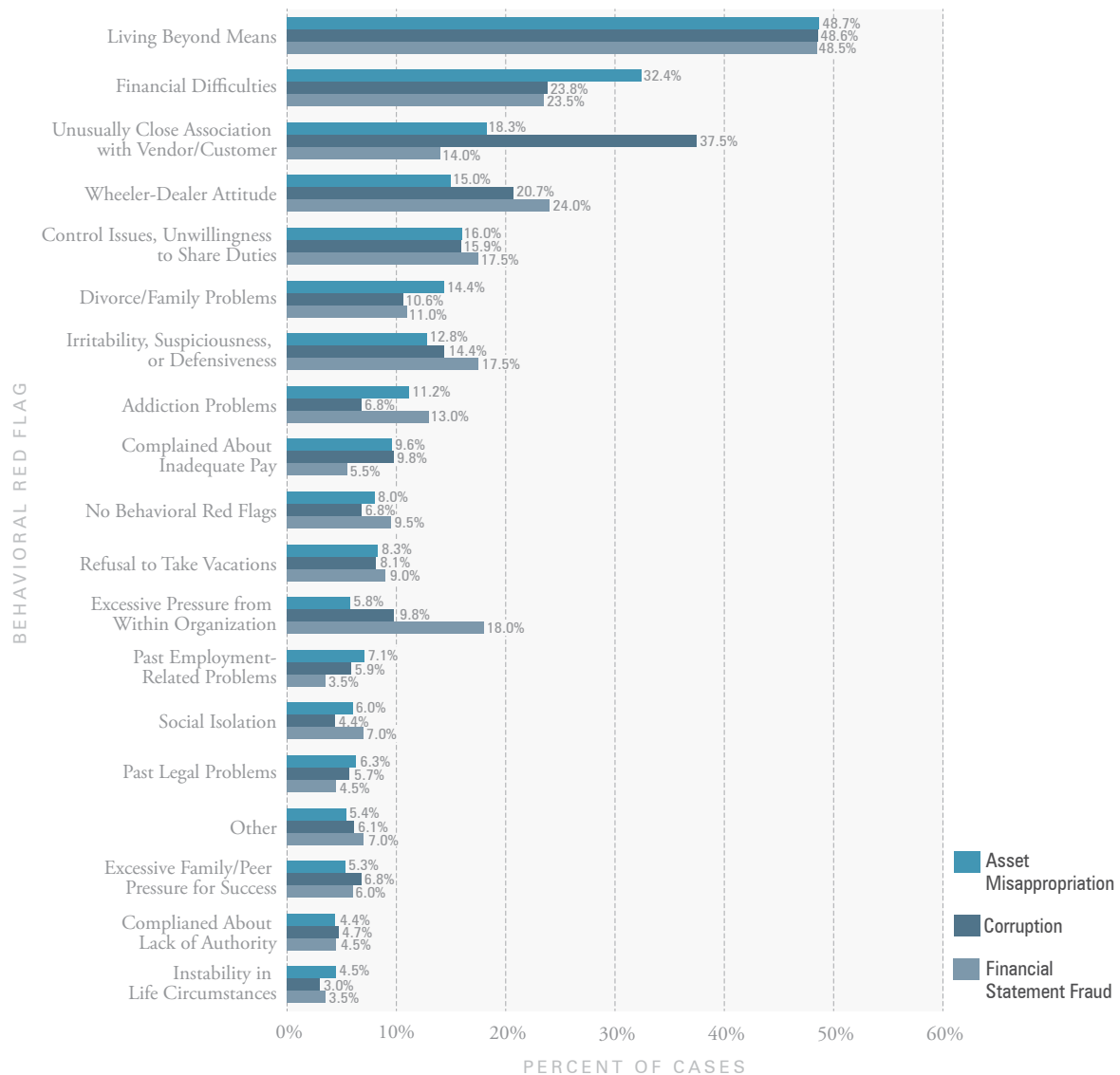


Perpetrators

Behavioral Red Flags Based on Scheme Type

In Figure 96 we analyzed behavioral red flags based on the type of fraud that was committed. Not surprisingly, those who engaged in corruption were much more likely than other fraudsters to have an unusually close association with a vendor or customer. Individuals who committed financial statement fraud had experienced excessive pressure to perform within their organizations in almost one-fifth of cases—much more than in either corruption or asset misappropriation schemes. And those who committed asset misappropriation were more likely to be experiencing known financial difficulties. Regardless of the type of fraud committed, living beyond means remained the most common behavioral red flag, occurring in nearly half of the cases in each category.

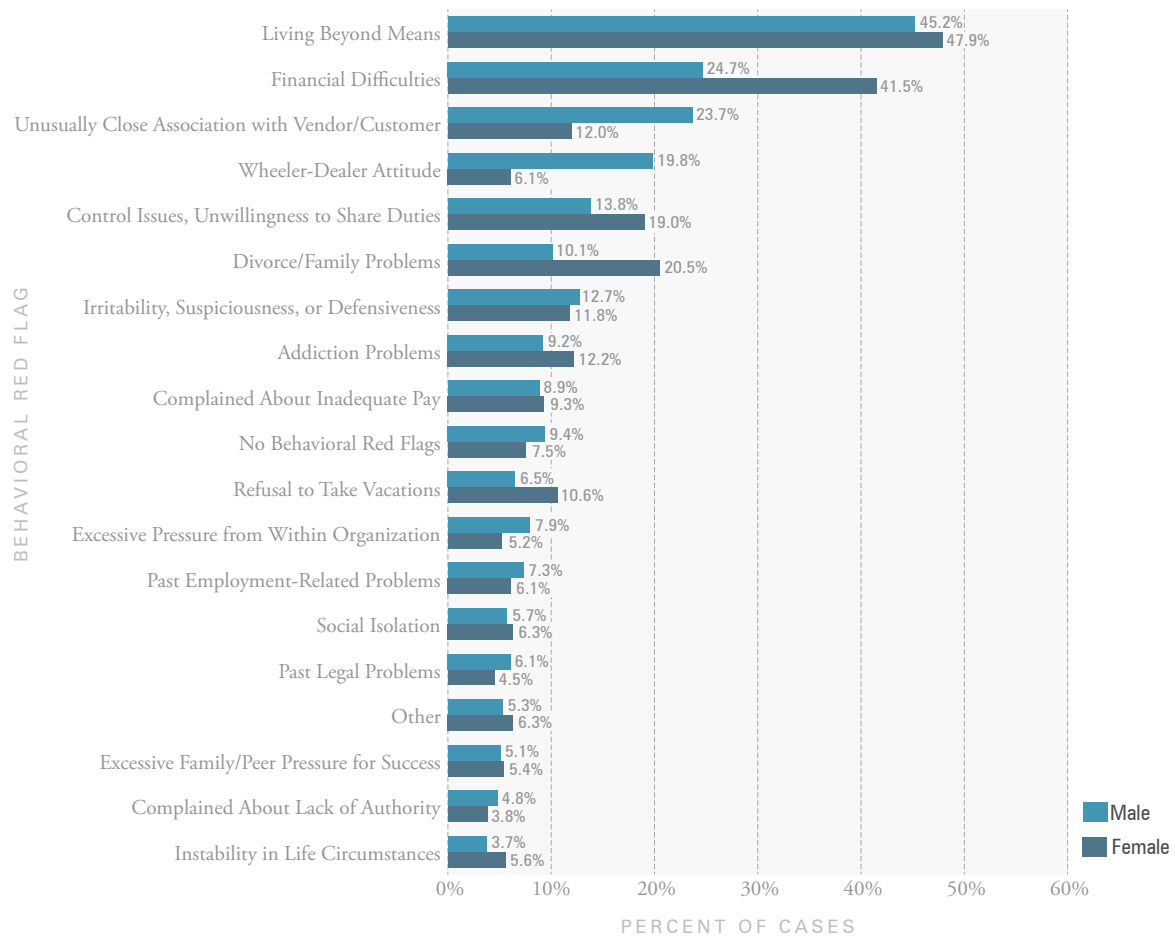
Figure 96: Behavioral Red Flags Based on Scheme Type



Behavioral Red Flags Based on Perpetrator’s Gender

On page 59, we discussed differences in fraud schemes that are associated with the gender of the perpetrator, and in Figure 97 we analyzed how behavioral red flags differ between men and women. Women were much more likely than men to commit fraud based on factors relating to financial need or life circumstances, such as general financial difficulties, divorce or family problems, and addiction issues. Men were much more often seen as having improper relationships with vendors or customers or evidencing a “wheeler-dealer” attitude involving generally unscrupulous or shrewd behavior.

Figure 97: Behavioral Red Flags Based on Perpetrator’s Gender

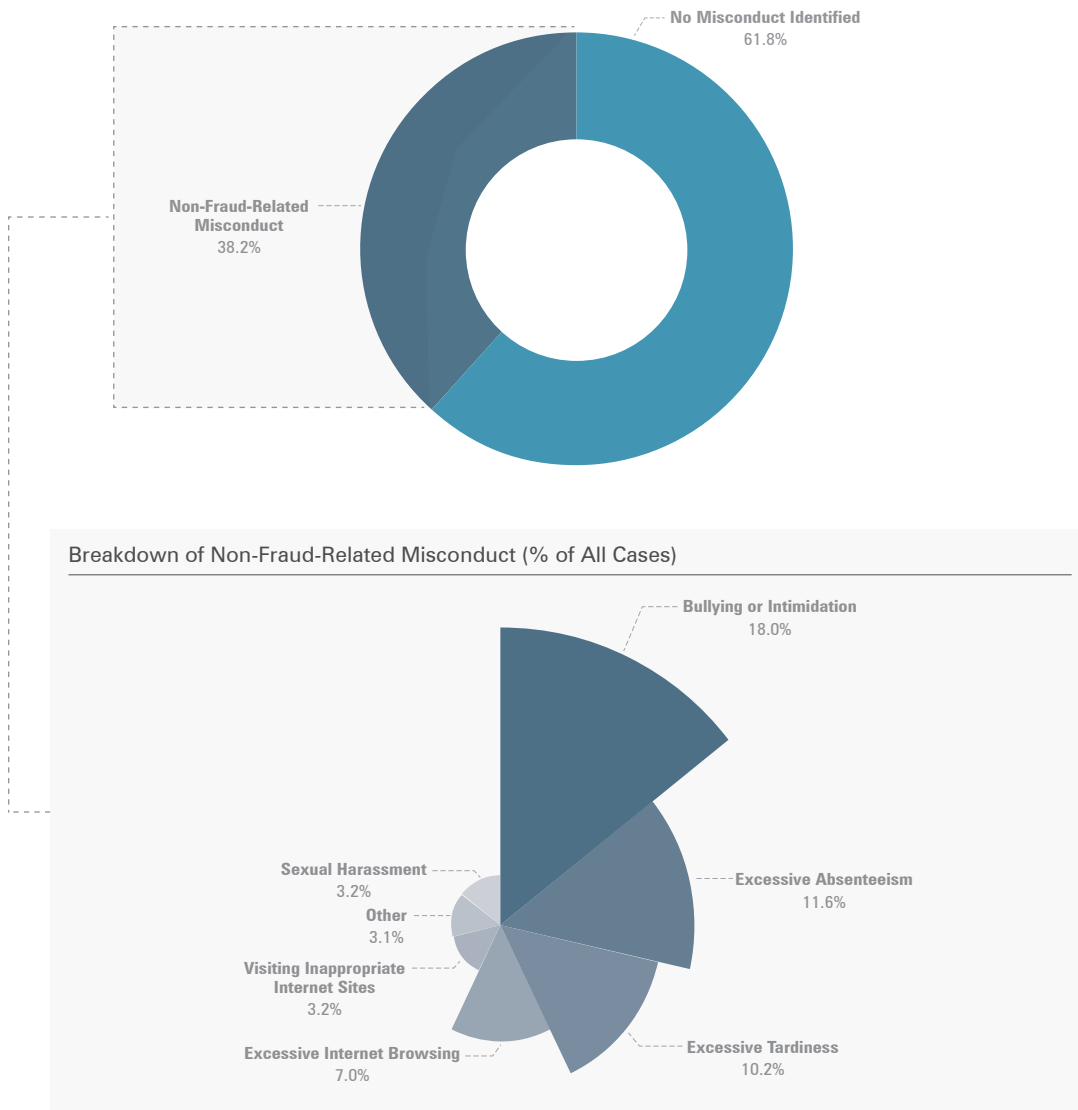


Perpetrators

Non-Fraud-Related Misconduct

To determine if there was a relationship between occupational fraud and other forms of workplace misconduct, we presented survey participants with a list of common workplace violations and asked them to identify any that the perpetrator had engaged in prior to or during the time of the fraud. As Figure 98 shows, nearly 40% of fraudsters had engaged in some form of non-fraud workplace violation. Among the cases where a violation was identified, bullying or intimidation was the most common, followed by excessive absenteeism and excessive tardiness.

Figure 98: Non-Fraud-Related Misconduct

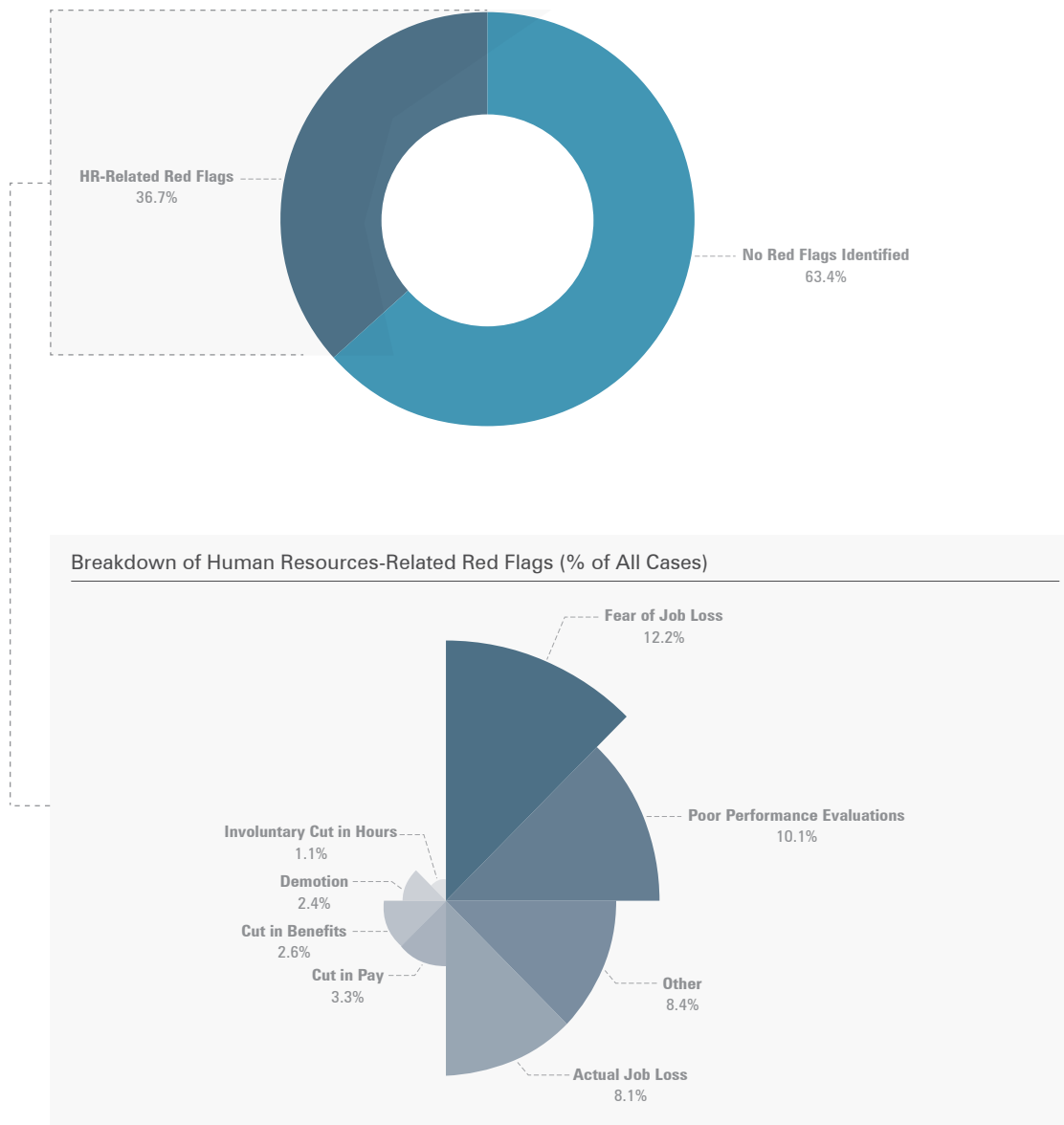


Human Resources-Related Red Flags

In addition to workplace violations, we also asked survey participants if the perpetrators had encountered any negative human resources-related events (such as poor performance evaluations, loss of pay or benefits, fear of job loss, etc.) prior to or during the time of the frauds. These types of events can cause financial stress or resentment toward the employer, both of which are factors commonly associated with occupational fraud.

In more than 63% of cases, no HR-related red flag was identified (see Figure 99). However, in 12.2% of cases, the fraud perpetrator had experienced fear of job loss, and in 10.1% the perpetrator had received poor performance evaluations.

Figure 99: Human Resources-Related Red Flags



Case Results

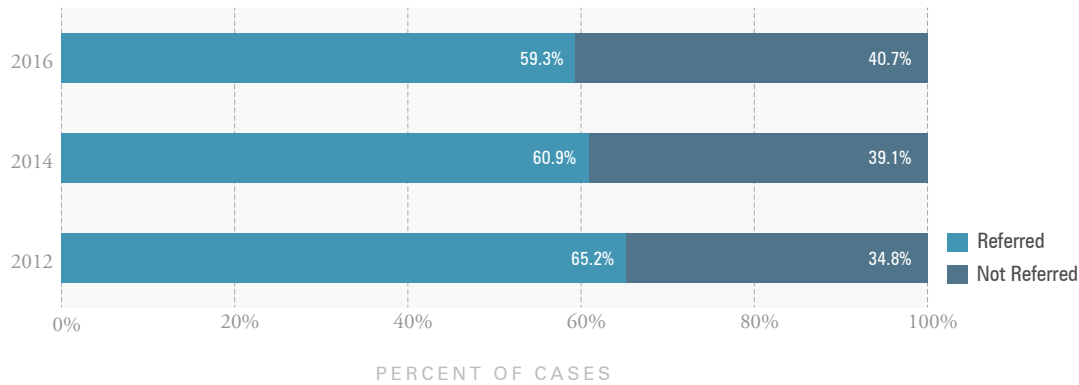


We asked respondents about the outcome of the cases they investigated, including whether the victim organizations referred cases for prosecution, whether they pursued a civil suit, and the underlying reasons for those decisions. Additionally, we asked respondents to provide information about punishment against the principal perpetrator and penalties against the victim organization.

Criminal Prosecutions

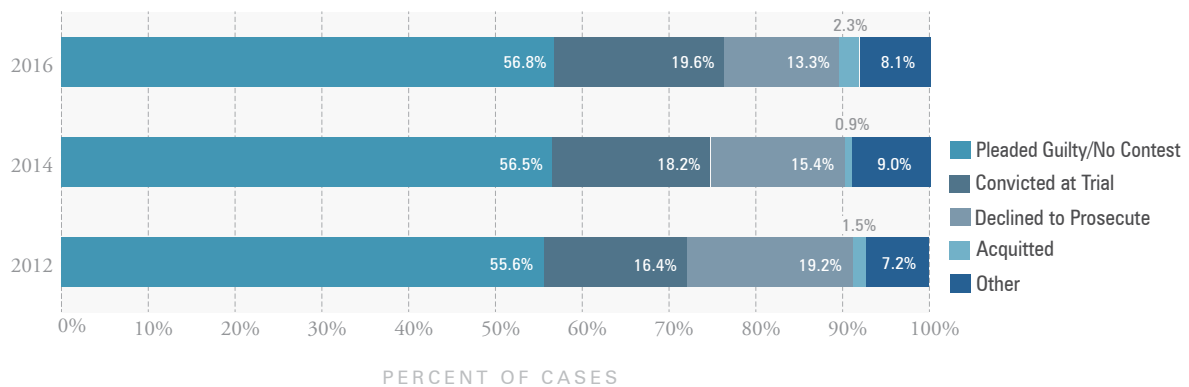
Over the last three reports, the percentage of cases referred to law enforcement declined slightly, from 65.2% in 2012 to 59.3% in 2016. In addition, the cases referred for prosecution tended to involve higher losses; the median loss in cases referred for criminal prosecution was \$230,000 compared to \$71,000 in cases not referred.

Figure 100: Cases Referred to Law Enforcement



Of the victim organizations that referred cases for prosecution, the results of those criminal actions for the past three reports are shown in Figure 101 (cases that are still pending were not included in this analysis). While the percentage of defendants who pleaded guilty or no contest has remained about the same over time, the rate of cases in which authorities declined to prosecute dropped from 19.2% in 2012 to 13.3% in 2016. Combining guilty pleas and convictions at trial, 76.4% of cases submitted for prosecution resulted in a finding of guilt in 2016, while 2.3% of such prosecutions ended in acquittal. Although the percentage of cases referred to prosecution decreased gradually from the 2012 report to the 2016 version (see Figure 100), the percentage of cases that prosecutors successfully pursued increased.

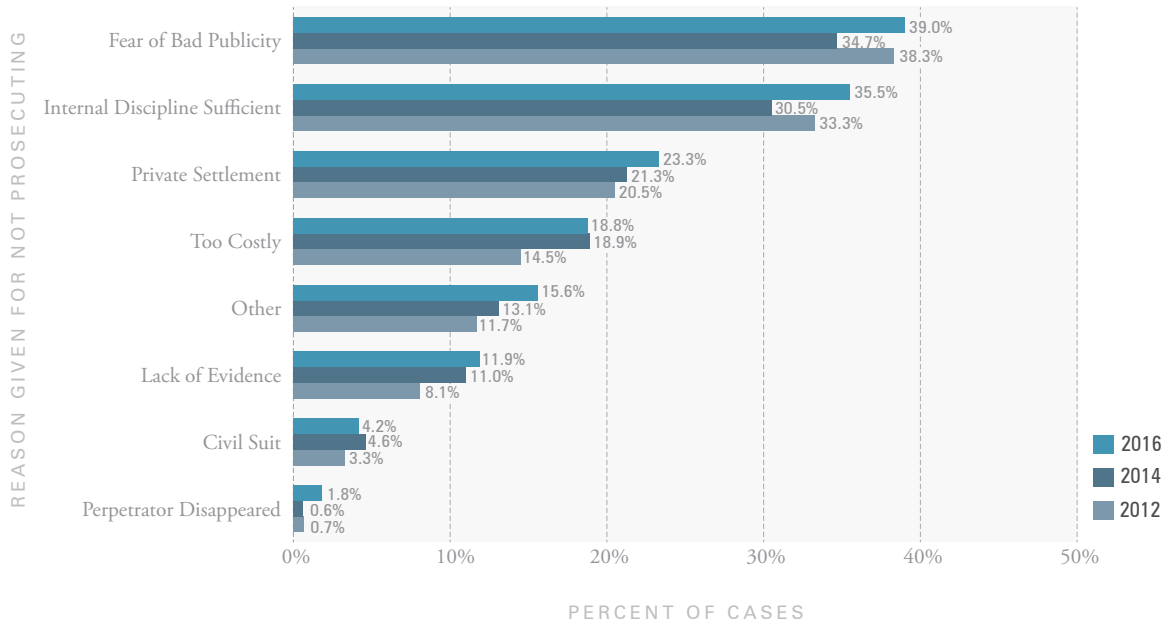
Figure 101: Results of Cases Referred to Law Enforcement



Case Results

Regarding cases that management did not refer to law enforcement, we asked our respondents to provide the reason(s) why. As in the previous two reports, the top three reasons for declining to refer were fear of bad publicity (39%), internal discipline considered sufficient (35.5%), and the parties reached a private settlement (23.3%).

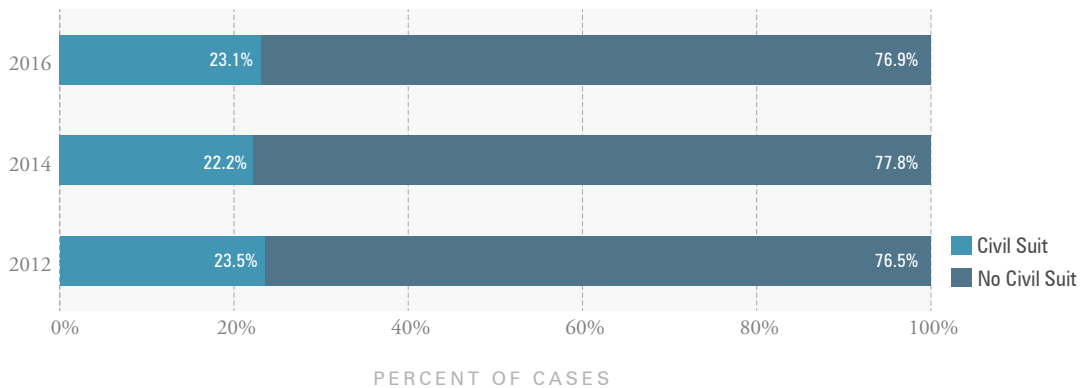
Figure 102: Reason(s) Case Not Referred to Law Enforcement



Civil Suits

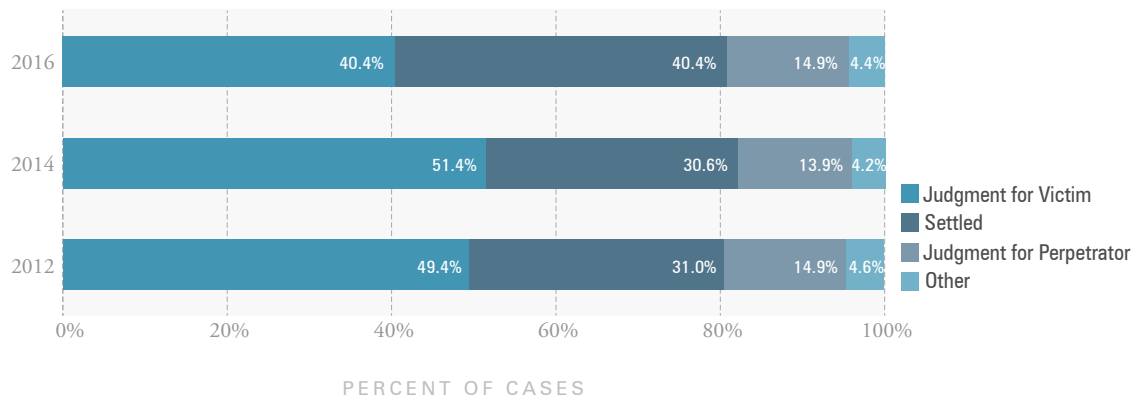
We also asked respondents to report on cases that resulted in a civil lawsuit. Figure 103 shows that less than one-fourth of occupational fraud cases resulted in a civil suit. This percentage has been fairly stable over the past three reports.

Figure 103: Cases Resulting in Civil Suit



Following the occurrence of a fraud, the victim organization might pursue civil litigation to help collect stolen assets. Figure 104 reveals a noticeable drop in judgments in favor of victim organizations in such civil suits—40.4% in the 2016 report, as opposed to 51.4% in the 2014 report. It appears that an increase in settlements mostly accounted for this change, rising from 30.6% of cases in the 2014 report to 40.4% of cases in the 2016 report. Judgments in favor of the suspect occurred in 14.9% of cases in the current data, with little change over the past three reports.

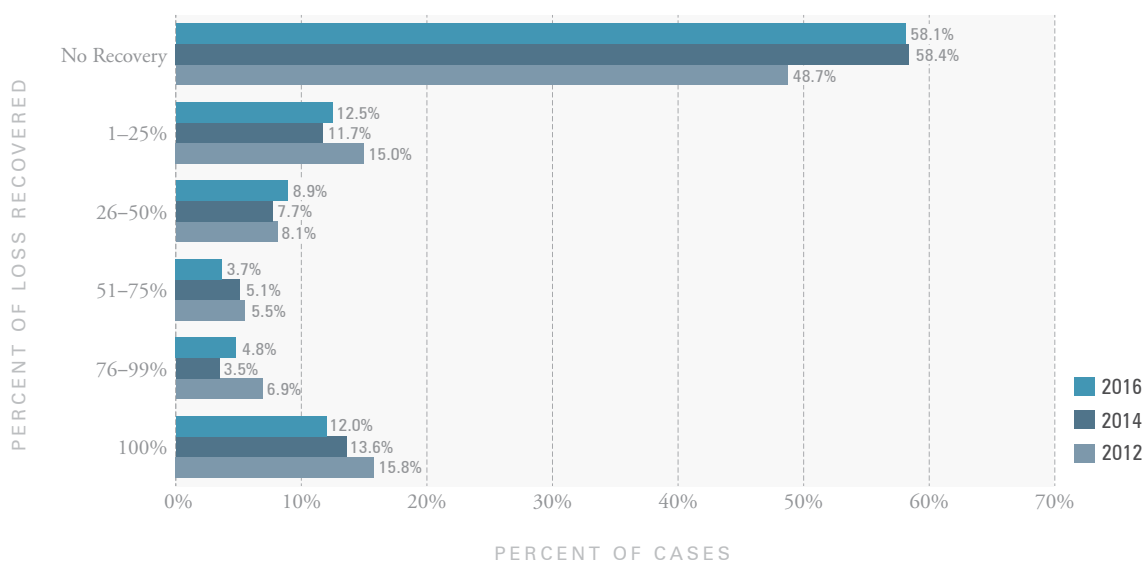
Figure 104: Results of Civil Suits



Recovery of Losses

We asked respondents to provide the percentage of the loss that the victim organization recovered, and the results are shown in Figure 105. The majority (58.1%) of victims had yet to recover any losses at the time of the survey, and only 12% of organizations had recovered all of their losses at that time. While many victims in our study might still be in the process of recovering losses, the data shows that such efforts can take time and might never result in a full recovery.

Figure 105: Recovery of Victim Organization’s Losses

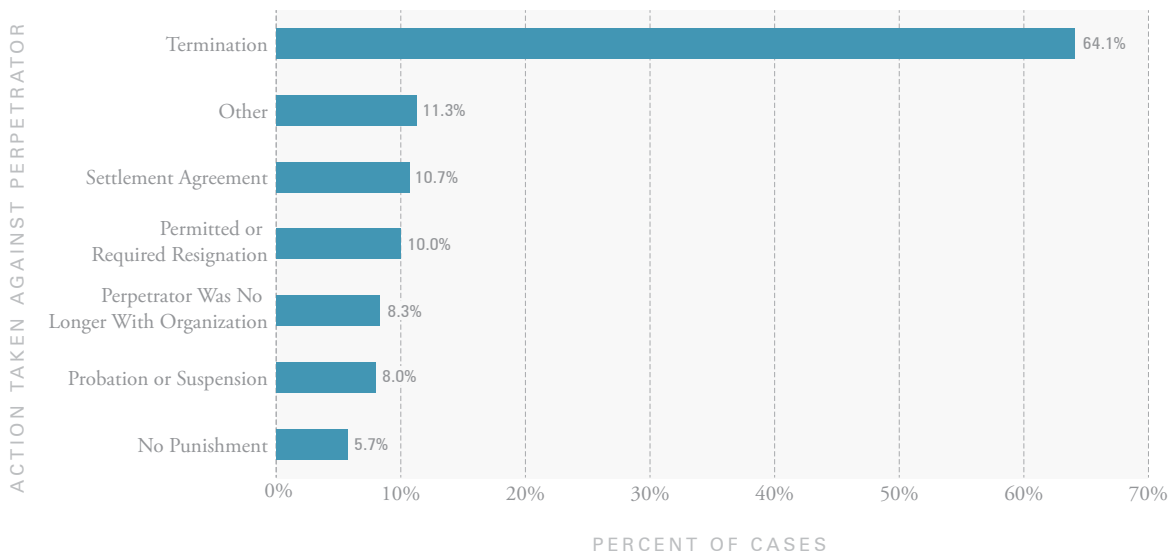


Case Results

Action Taken Against Perpetrator

Beyond recovery of losses, punishing perpetrators of occupational fraud can be an important part of the victim organization's fraud prevention program, as it sends a clear message about management's anti-fraud stance. Figure 106 shows that termination was by far the most common punishment for occupational fraudsters (64.1% of cases). In some instances, suspects received softer punishments, such as resignation (10%) or probation or suspension (8%). How best to handle occupational fraud can vary depending on the circumstances and the best interests of the organization. Still, it is interesting that 5.7% of suspected perpetrators received no punishment.

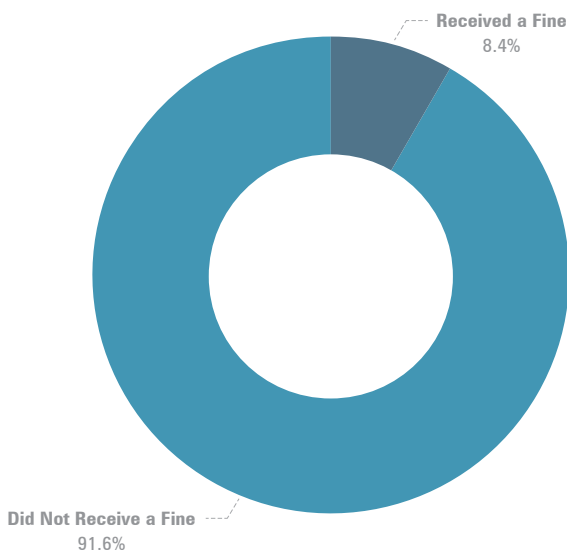
Figure 106: Action Taken Against Perpetrator



Fines Against Victim Organization

While we generally think of individual perpetrators being responsible for fraud, sometimes organizations are punished for having inadequate controls or otherwise allowing the fraud to occur. For the first time, we asked respondents about fines levied against the victim organization. Figure 107 shows that 8.4% of victim organizations were fined as a result of the fraud.

Figure 107: Fines Against Victim Organizations



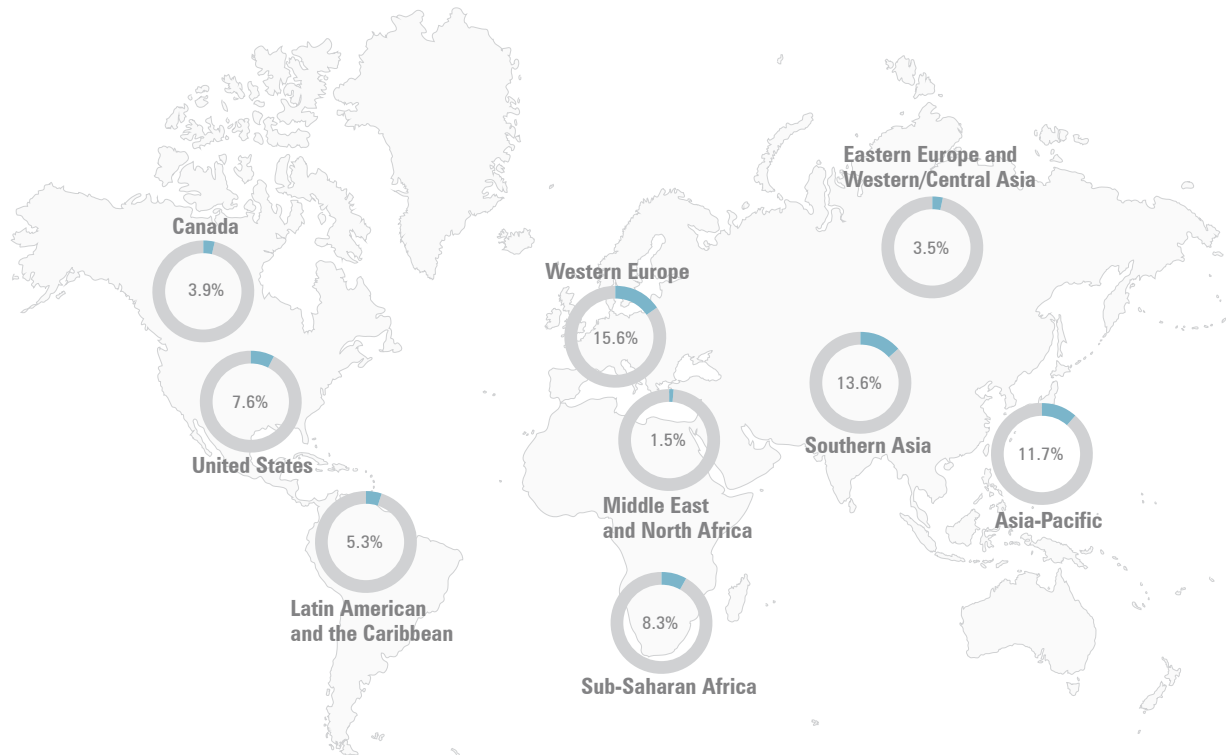
Adding Injury to Injury: Fine Amounts

An additional fraud risk for many organizations is the potential that they will receive fines from authorities on top of any fraud losses. For the organizations in our study that received a monetary penalty:



In addition to looking at the overall rate of organizations fined as a result of occupational fraud, we also compared fines regionally. Figure 108 shows the proportion of cases in each region that resulted in a fine against the victim organization. Organizations in Western Europe had the highest proportion of fines (15.6%), while the Middle East and North Africa had the lowest (1.5%).

Figure 108: Fines Against Victim Organizations by Region



Methodology



The 2016 *Report to the Nations on Occupational Fraud and Abuse* is based on the results of the 2015 *Global Fraud Survey*, an online survey opened to 41,788 Certified Fraud Examiners (CFEs) from July 2015 to October 2015. As part of the survey, respondents were asked to provide a detailed narrative of the single largest fraud case they had investigated since January 2014. Additionally, after completing the survey the first time, respondents were provided the option to submit information about a second case that they investigated.

Cases submitted were required to meet the following four criteria:

1. The case must have involved occupational fraud (defined as internal fraud, or fraud committed by a person against the organization for which he or she works).

2. The investigation must have occurred between January 2014 and the time of survey participation.
3. The investigation must have been complete at the time of survey participation.
4. The respondent must have been reasonably sure the perpetrator(s) was (were) identified.

Respondents were then presented with 81 questions to answer regarding the particular details of the fraud case, including information about the perpetrator, the victim organization, and the methods of fraud employed, as well as fraud trends in general. We received 7,497 total responses to the survey, 2,410 of which were usable for purposes of this report. The data contained herein is based solely on the information provided in these 2,410 survey responses.

Analysis Methodology

In calculating the percentages discussed throughout this report, we used the total number of complete and relevant responses for the question(s) being analyzed. Specifically, we excluded any blank responses or instances where the participant indicated that he or she did not know the answer to a question. Consequently, the total number of cases included in each analysis varies.

In addition, several survey questions allowed participants to select more than one answer. Therefore, the sum of percentages in many figures throughout the report exceeds 100%.

Unless otherwise indicated, all loss amounts discussed throughout the report are calculated using median loss rather than mean, or average, loss. Average losses were skewed by a limited number of very high-dollar frauds. Using median loss provides a more conservative—and we believe more accurate—picture of the typical impact of occupational fraud schemes. Additionally, we excluded median loss calculations for categories for which there were fewer than 10 responses.

Because the direct losses caused by financial statement frauds are typically spread among numerous stakeholders, obtaining an accurate estimate for this amount is extremely difficult. Consequently, for schemes involving financial statement fraud, we asked survey participants to provide the gross amount of the financial statement misstatement (over- or under-statement) involved in the scheme. All losses reported for financial statement frauds throughout this report are based on those reported amounts.

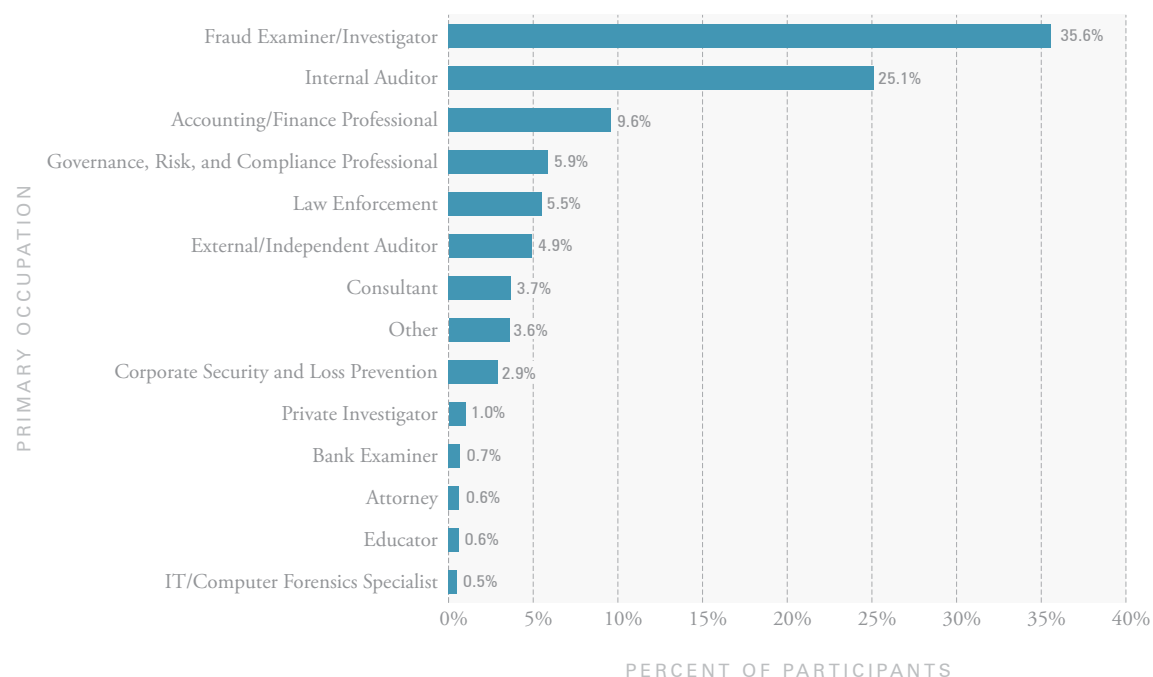
Who Provided the Data?

To provide context for the survey responses and to understand who investigates cases of occupational fraud, we asked respondents to provide certain information about their professional experience and qualifications.

Primary Occupation

More than one-third of survey respondents noted their primary occupation as fraud examiner/investigator, and another quarter of respondents were internal auditors.

Figure 109: Primary Occupation of Survey Participants

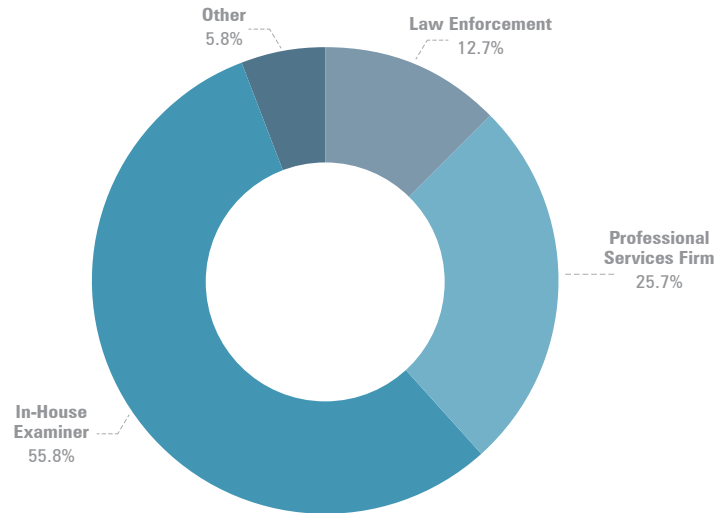


Methodology

Nature of Fraud Examination Role

In addition to the primary occupation, we asked respondents to provide information about the nature of their role regarding fraud examinations. More than 55% of survey participants indicated that they worked in-house (i.e., conducted fraud examinations within a single company or agency); almost 26% worked for a professional services firm that conducted fraud examinations on behalf of other companies, individuals, or agencies; and about 13% worked for a law enforcement or government agency and conducted fraud examinations under the authority of that agency.

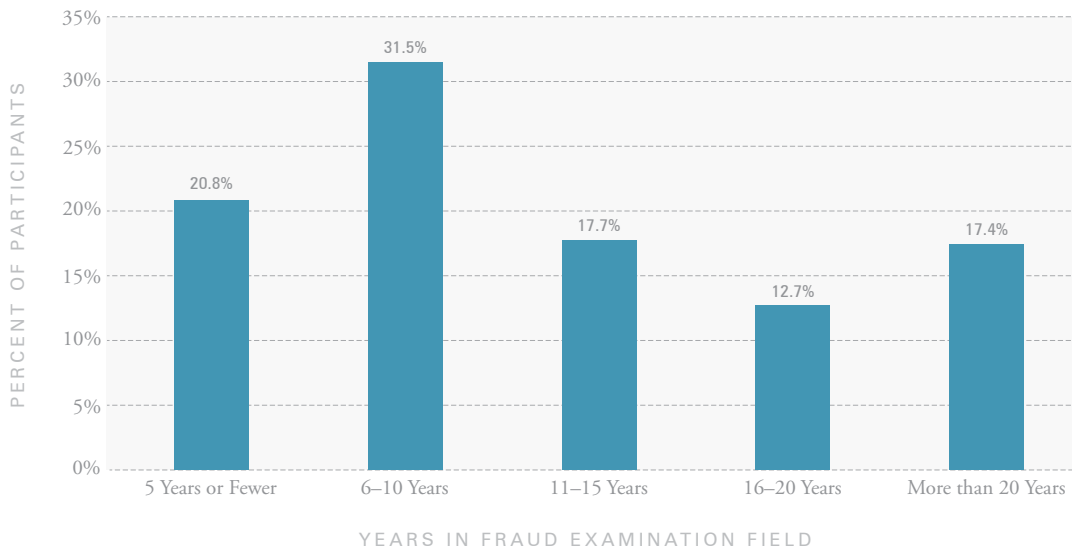
Figure 110: Nature of Survey Participants' Fraud Examination Work



Experience

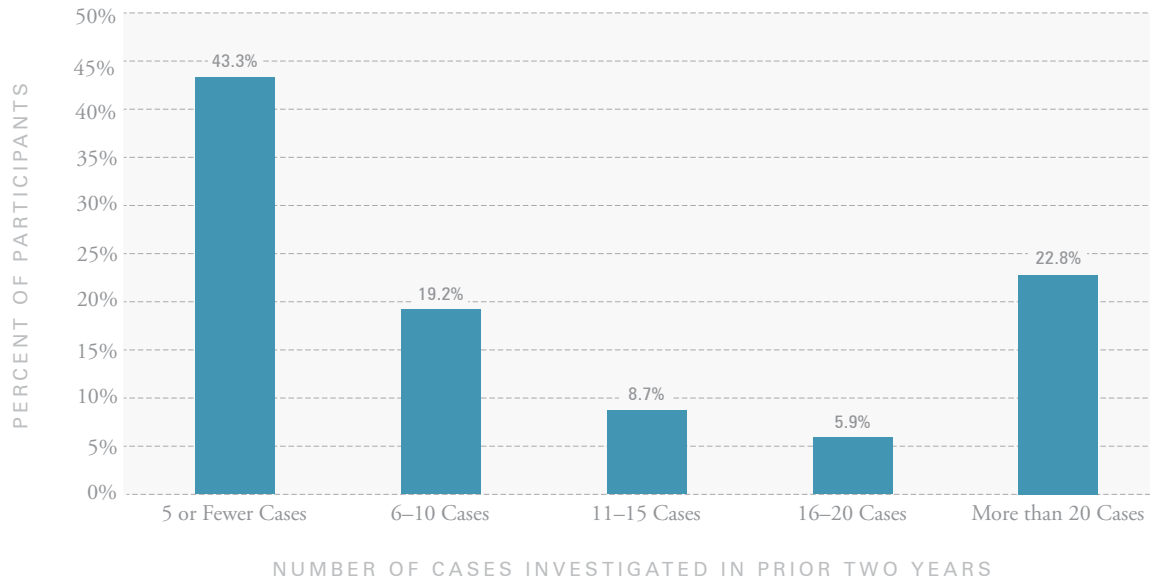
Survey respondents had a median ten years of fraud examination experience, with just over 30% of respondents having more than 15 years of experience in the fraud examination field.

Figure 111: Experience of Survey Participants



Respondents also provided information about the number of total fraud cases they worked on in the prior two years. As reflected in Figure 112, approximately 23% of respondents investigated more than 20 cases, while about 43% investigated five or fewer cases during that time.

Figure 112: Cases Investigated by Survey Participants



SURVEY RESPONDENTS HAD A **MEDIAN TEN YEARS OF FRAUD EXAMINATION EXPERIENCE.**

Appendix

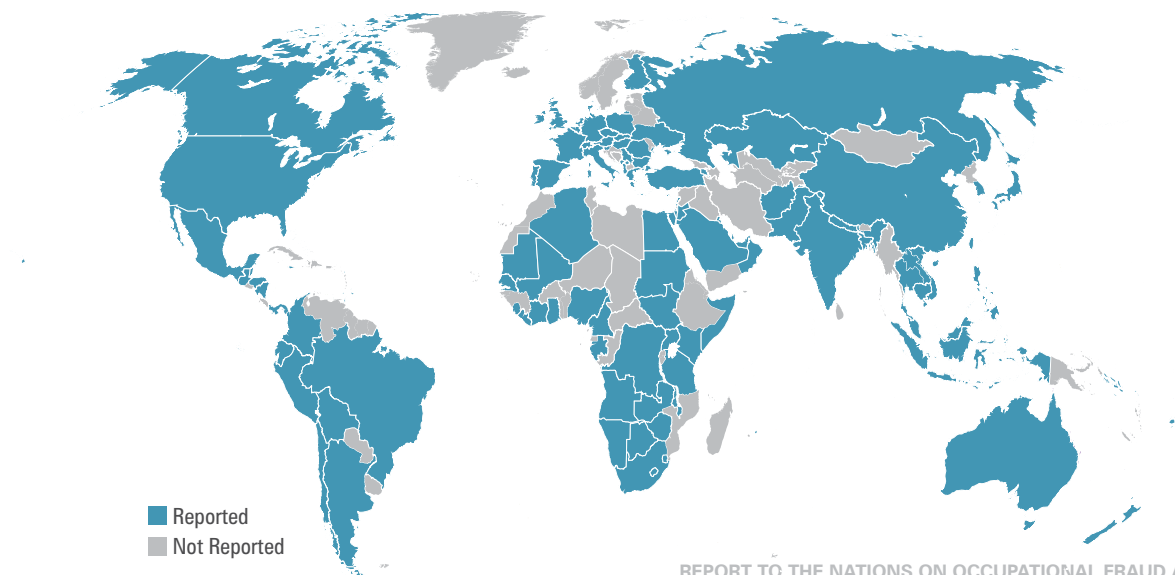
Figure 113: Breakdown of Geographic Regions by Country

Asia-Pacific (221 Cases)		Eastern Europe and Western/Central Asia (98 Cases)	
Country	Number of Cases	Country	Number of Cases
Australia	26	Albania	1
Cambodia	1	Armenia	3
China	64	Bulgaria	5
East Timor	2	Czech Republic	8
Fiji	2	Hungary	2
Indonesia	42	Kazakhstan	5
Japan	3	Kosovo	1
Laos	1	Montenegro	2
Malaysia	11	Poland	8
New Zealand	10	Romania	11
Philippines	29	Russia	21
Samoa	3	Serbia	4
Singapore	14	Slovakia	8
Solomon Islands	1	Slovenia	2
South Korea	3	Turkey	15
Taiwan	3	Ukraine	2
Thailand	4		
Vietnam	2		
Latin America and the Caribbean (112 Cases)		Middle East and North Africa (79 Cases)	
Antigua and Barbuda	2	Algeria	1
Argentina	12	Bahrain	3
Bahamas	2	Cyprus	3
Barbados	1	Egypt	5
Belize	1	Israel	2
Bolivia	1	Jordan	2
Brazil	18	Kuwait	4
Chile	4	Lebanon	5
Colombia	14	Oman	7
Ecuador	2	Qatar	7
Grenada	1	Saudi Arabia	13
Guatemala	1	United Arab Emirates	27
Honduras	1		
Jamaica	2		
Mexico	36		
Nicaragua	1		
Panama	2		
Peru	4		
Trinidad and Tobago	7		

Southern Asia (98 Cases)	
Country	Number of Cases
Afghanistan	4
Bangladesh	4
India	77
Nepal	2
Pakistan	11
Western Europe (110 Cases)	
Austria	4
Belgium	4
Denmark	2
Finland	3
France	7
Germany	15
Greece	7
Ireland	2
Italy	9
Netherlands	7
Portugal	5
Spain	6
Switzerland	9
United Kingdom	30

Sub-Saharan Africa (285 Cases)	
Country	Number of Cases
Angola	4
Botswana	2
Cameroon	2
Congo, Democratic Republic of the	4
Cote d'Ivoire (Ivory Coast)	2
Gabon	1
Gambia	1
Ghana	11
Kenya	41
Lesotho	1
Liberia	5
Malawi	3
Mali	1
Mauritania	2
Mauritius	4
Namibia	1
Nigeria	70
Senegal	3
Sierra Leone	1
Somalia	1
South Africa	87
South Sudan	1
Sudan	1
Swaziland	1
Tanzania	8
Uganda	11
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Figure 114: Countries with Reported Cases



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Fraud Prevention Checklist

The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist is designed to help organizations test the effectiveness of their fraud prevention measures.

1. Is ongoing anti-fraud training provided to all employees of the organization?

- Do employees understand what constitutes fraud?
- Have the costs of fraud to the company and everyone in it — including lost profits, adverse publicity, job loss, and decreased morale and productivity — been made clear to employees?
- Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe that they can speak freely?
- Has a policy of zero-tolerance for fraud been communicated to employees through words and actions?

2. Is an effective fraud reporting mechanism in place?

- Have employees been taught how to communicate concerns about known or potential wrongdoing?
- Is there an anonymous reporting channel, such as a third-party hotline, available to employees?
- Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?
- Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?
- Do reporting policies and mechanisms extend to vendors, customers and other outside parties?

3. To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?

- Is possible fraudulent conduct aggressively sought out, rather than dealt with passively?
- Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?
- Are surprise fraud audits performed in addition to regularly scheduled audits?
- Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

4. Is the management climate/tone at the top one of honesty and integrity?

- Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?
- Are performance goals realistic?
- Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and that are used to determine performance-related compensation?
- Has the organization established, implemented and tested a process for oversight of fraud risks by the board of directors or others charged with governance (e.g., the audit committee)?

5. **Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?**
6. **Are strong anti-fraud controls in place and operating effectively, including the following?**
 - Proper separation of duties
 - Use of authorizations
 - Physical safeguards
 - Job rotations
 - Mandatory vacations
7. **Does the internal audit department, if one exists, have adequate resources and authority to operate effectively and without undue influence from senior management?**
8. **Does the hiring policy include the following (where permitted by law)?**
 - Past employment verification
 - Criminal and civil background checks
 - Credit checks
 - Drug screening
 - Education verification
 - References checks
9. **Are employee support programs in place to assist employees struggling with addiction, mental/emotional health, family or financial problems?**
10. **Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?**
11. **Are anonymous surveys conducted to assess employee morale?**

Glossary of Terminology

Asset misappropriation: A scheme in which an employee steals or misuses the employing organization's resources (e.g., theft of company cash, false billing schemes, or inflated expense reports)

Billing scheme: A fraudulent disbursement scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases (e.g., employee creates a shell company and bills employer for services not actually rendered; employee purchases personal items and submits an invoice to employer for payment)

Cash larceny: A scheme in which an incoming payment is stolen from an organization after it has been recorded on the organization's books and records (e.g., employee steals cash and checks from daily receipts before they can be deposited in the bank)

Cash-on-hand misappropriations: A scheme in which the perpetrator misappropriates cash kept on hand at the victim organization's premises (e.g., employee steals cash from a company vault)

Check tampering scheme: A fraudulent disbursement scheme in which a person steals his or her employer's funds by intercepting, forging, or altering a check or electronic payment drawn on one of the organization's bank accounts (e.g., employee steals blank company checks and makes them out to himself or an accomplice; employee steals an outgoing check to a vendor and deposits it into his or her own bank account)

Corruption: A scheme in which an employee misuses his or her influence in a business transaction in a way that violates his or her duty to the employer in order to gain a direct or indirect benefit (e.g., schemes involving bribery or conflicts of interest)

Employee support programs: Programs that provide support and assistance to employees dealing with personal issues or challenges, such as counseling services for drug, family, or financial problems

Expense reimbursements scheme: A fraudulent disbursement scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses

(e.g., employee files fraudulent expense report, claiming personal travel, nonexistent meals)

Financial statement fraud: A scheme in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports (e.g., recording fictitious revenues, understating reported expenses, or artificially inflating reported assets)

Hotline: A mechanism to report fraud or other violations, whether managed internally or by an external party

Management review: The process of management reviewing organizational controls, processes, accounts, or transactions for adherence to company policies and expectations

Non-cash misappropriations: Any scheme in which an employee steals or misuses non-cash assets of the victim organization (e.g., employee steals inventory from a warehouse or storeroom; employee steals or misuses confidential customer financial information)

Occupational fraud: The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets

Payroll scheme: A fraudulent disbursement scheme in which an employee causes his or her employer to issue a payment by making false claims for compensation (e.g., employee claims overtime for hours not worked; employee adds ghost employees to the payroll)

Primary perpetrator: The person who worked for the victim organization and who was reasonably confirmed as the primary culprit in the case

Register disbursements scheme: A fraudulent disbursement scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash (e.g., employee fraudulently voids a sale on his or her cash register and steals the cash)

Skimming: A scheme in which an incoming payment is stolen from an organization before it is recorded on the organization's books and records (e.g., employee accepts payment from a customer but does not record the sale and instead pockets the money)

About the ACFE

Founded in 1988 by Dr. Joseph T. Wells, CFE, CPA, the ACFE is the world's largest anti-fraud organization and premier provider of anti-fraud training and education. Together with more than 75,000 members in more than 150 countries, the ACFE is reducing business fraud worldwide and providing the training and resources needed to fight fraud more effectively.

The ACFE provides educational tools and practical solutions for anti-fraud professionals through initiatives including:

- Global conferences and seminars led by anti-fraud experts
- Instructor-led, interactive professional training
- Comprehensive resources for fighting fraud, including books, self-study courses and articles
- Leading anti-fraud publications, including *Fraud Magazine*™, *The Fraud Examiner* and *FraudInfo*
- Local networking and support through more than 170 ACFE chapters worldwide
- Anti-fraud curriculum and educational tools for colleges and universities

The positive effects of anti-fraud training are far-reaching. Clearly, the best way to combat fraud is to educate anyone engaged in fighting fraud on how to effectively prevent, detect and investigate it. By educating, uniting and supporting the global anti-fraud community with the tools to fight fraud more effectively, the ACFE is reducing business fraud worldwide and inspiring public confidence in the integrity and objectivity of the profession. The ACFE offers its members the opportunity for professional certification. The Certified Fraud Examiner (CFE) credential is preferred by businesses and government entities around the world and indicates expertise in fraud prevention and detection.

Membership

Immediate access to world-class anti-fraud knowledge and tools is a necessity in the fight against fraud.

Members of the ACFE include accountants, internal auditors, fraud investigators, law enforcement officers, lawyers, business leaders, risk/compliance professionals and educators, all of whom have access to expert training, educational tools and resources. More than 75,000 members from all over the world have come to depend on the ACFE for solutions to the challenges they face in their professions. Whether their career is focused exclusively on preventing and detecting fraudulent activities or they just want to learn more about fraud, the ACFE provides the essential tools and resources necessary for anti-fraud professionals to accomplish their objectives. To learn more, visit ACFE.com or call (800) 245-3321 / +1 (512) 478-9000.

Certified Fraud Examiners

Certified Fraud Examiners (CFEs) are anti-fraud experts who have demonstrated knowledge in four critical areas: Financial Transactions and Fraud Schemes, Law, Investigation, and Fraud Prevention and Deterrence. In support of CFEs and the CFE credential, the ACFE:

- Provides bona fide qualifications for CFEs through administration of the CFE Exam
- Requires CFEs to adhere to a strict code of professional conduct and ethics
- Serves as the global representative for CFEs to business, government and academic institutions
- Provides leadership to inspire public confidence in the integrity, objectivity and professionalism of CFEs



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AICPA

Audit Committee Toolkit

The AICPA
**AUDIT COMMITTEE
TOOLKIT**

Government Organizations, 3rd Edition

AICPA[®]

In cooperation with: **CNA** and
Audit Committee Effectiveness Center

Acknowledgements

The *AICPA Audit Committee Toolkit: Government Entities* was developed by AICPA members working in and with government entities. We are grateful to the members of the task force and the organizations that provided them the opportunity to participate in this project for their dedication, professional expertise, and hard work.

We are pleased to recognize the efforts of the following leaders on the task force:

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Preface

Since it was launched in late 2003, the AICPA Audit Committee Effectiveness Center¹ has earned a reputation as a respected source for audit tools, forms, and information by both AICPA membership and the business public. The center's two main features—The Audit Committee Toolkit series and the Audit Committee Matching System—are part of the AICPA's continuing efforts to support public interest in audit-related issues.

This 3rd edition of the *Audit Committee Toolkit: Government Entities* focuses solely on government entities, and is designed for use by the following groups:

- All government entities, regardless of size
- Board and audit committee members of government entities
- CEO, CFO, chief audit executives, and other key staff positions of government entities
- External and internal auditors

This edition features updates and revisions that reflect significant changes and updates to the COSO framework and regulations and standards that have occurred since the last edition. This toolkit is organized into the following subgroups:

- Audit Committee Administration
- Audit Committee Key Responsibilities
- Audit Committee Performance Evaluations
- Audit Committee Other Tools (risk management, resources)

This edition of the *Audit Committee Toolkit: Government Entities* is accompanied by a download of Microsoft Word files of all the tools so you can modify and customize them to fit your audit committee's needs. Visit www.cpa2biz.com/governmenttoolkit to access the files.

The Audit Committee Matching System (ACMS) offers a way to find CPAs who are willing to serve on corporate boards and audit committees. This free service is available to any organization that needs the CPA skillset in those roles. We encourage AICPA members to register on ACMS, and anyone can visit the online center to search the database using defined criteria. The AICPA offers no screening of candidates or companies—each party must perform its own due diligence on the other party.

The AICPA is grateful to CNA for its continued sponsorship of the Audit Committee Effectiveness Center. It is through their support that we are able to publish this book.

If you have questions on how to use the tools contained in this book, suggestions for new or additional tools, or other feedback, please write to us at acms@aicpa.org.

¹ You can visit the center online at www.aicpa.org/FORTHEPUBLIC/AUDITCOMMITTEEEFFECTIVENESS/Pages/ACEC.aspx

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Part I: Audit Committee Administration

Chapter 1: Audit Committee Member Roles and Responsibilities

Overview: Audit committee roles and responsibilities depend on the governing body and management structure of a government entity and, as presented here, are not intended to be tailored to all types of government structures. As such, the content presented in this chapter is a best practice for government entities.

This tool uses the term *governing body* to describe those in government entities that have the ultimate authority and responsibility for accountability of that government's public resources. At the federal, state, and local levels of government, the governing body may be a federal agency department head, legislative body, elected official(s), governing board, supervisory board, council, or any designee established by law or charter. This tool also refers generically to chief executive officers, chief financial officers, and chief audit executives for positions in government entities that are responsible for management, financial and accounting, and internal audit matters.

Government entities are faced with ongoing challenges related to the governance of their organization, risks associated with achieving their organization's objectives, and compliance with revised and emerging laws and regulations. Responsibilities are ultimately identified by the governing body and assigned to various governing committees, including the audit committee. Delegation of responsibilities and roles of the audit committee varies from entity to entity and continues to evolve. Beyond their responsibility for ensuring reasonably accurate and transparent information to legislatures and other interested parties, audit committee members are being asked to address increasing challenges.

Audit committees generally consist of a minimum of three independent members, at least one of whom is a "financial expert."¹ Other key qualifications may include risk management expertise, and broad government, business, or leadership experience. Audit committee responsibilities vary from organization to organization.

The following information provides areas to consider as an audit committee's responsibilities are defined, assigned, and implemented. In addition to the items discussed, your government entity should consult concurrently with your identified experts, such as legal, accounting, auditing, risk management, or compliance.

¹ A financial expert is an individual who possesses, among other attributes: (a) an understanding of generally accepted accounting principles (in this case, the accounting standards issued by the Governmental Accounting Board (GASB) or the Federal Accounting Standards Advisory Board (FASAB)) and financial statements; (b) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves; (c) experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth, depth, and level of complexity of accounting issues that can reasonably be expected to be raised by the government entity's financial statements, or experience actively supervising one or more persons engaged in such activities; (d) an understanding of internal control and the procedures for financial reporting; and (e) an understanding of audit committee functions.

The audit committee assists the governing body in its oversight of

- integrity of the organization’s financial statements;
- internal control including internal control over financial reporting;
- independent auditor’s qualifications, independence, and performance;
- internal audit function’s qualifications, independence, and performance;
- the organization’s risk management and overall governance process; and
- the organization’s ethics and compliance program, which includes legal and regulatory requirements.

Specific responsibilities assigned to an audit committee are set forth in an audit committee charter (see chapter 2, “Audit Committee Charter Matrix,” in this toolkit for more information) that is approved by the governing body. An audit committee charter should address the audit committee process, procedures, and responsibilities. Audit committee responsibilities can vary by government entity due to factors such as the size of the entity, the type of entity, and the complexity of the government entity’s service or business model.

The following illustrative lists, which are not intended to be complete, address the overall audit committee process, procedures, and oversight responsibilities, as well as best practices for audit committee members.

Audit Committee Process and Procedures

- Develop an audit committee charter and obtain approval from the governing body.
- Conduct an annual review of the audit committee charter.
- Set an agenda for the audit committee meetings based on the audit committee charter and other relevant issues.
- Ensure meeting minutes are prepared and approved by the audit committee.
- Provide audit committee reporting responsibilities to the governing body.
- Educate the other governing body members on the understanding of financial statements, financial statements risks, and internal control over financial reporting.
- Prepare an annual audit committee report.
- Conduct an annual self-assessment of effectiveness and efficiency of the audit committee.

- Conduct regularly scheduled and documented meetings with the independent external auditor,² chief audit executive (leader of the internal audit function), as well as the general counsel, head of the governing body, senior management (for example, the CEO and CFO), and others as needed. These meetings are generally conducted in an executive session at the conclusion of each regularly scheduled meeting.
- Consider the development of an annual calendar based on the audit committee charter.

Oversight of the Financial Reporting Process

- Review critical accounting policies, practices, judgments, estimates, significant issues, significant transactions, adjustments, unusual items, complex issues, and business arrangements.
- Review annual and interim financial statements including management’s discussion and analysis and budgetary comparisons for structural compatibility and period to period consistency.
- Review annual audited financial statements including any federal Office of Management and Budget (OMB) reports.³
- Obtain explanations from management on all significant variances.
- Question management and the independent auditor about significant financial reporting issues.
- Review comparative data from other comparative government entities to perform reasonableness tests of the entity’s results.
- Facilitate the resolution of disagreements between management and the independent auditor regarding financial reporting issues.
- Determine when a subject matter expert is required and hire advisers when needed. (See chapter 7, “Engaging Independent Counsel and Other Advisers,” in this toolkit for more information.)
- Review management letters containing the independent auditor’s recommendations and management’s responses to those recommendations.
- Determine that adequate procedures are in place for reviewing the government entity’s disclosure of financial information extracted or derived from its financial statements and assess periodically the adequacy of these procedures.

² The independent auditor may be mandated by law or regulation to perform audits for external reporting purposes. In turn, an Office of Inspector General (OIG) or similar government entity may contract an independent public accountant to perform the audit.

³ An example of an OMB report includes financial statements required by Title 2 of the Code of Regulation Section C: Subpart F, *Audit Requirements (Circulars A-133 and A-50)* published December 26, 2013 [Previously, these financial statements were required by OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*].

- Understand complex accounting and reporting topics and how management addresses them.
- Understand significant judgments and estimates used by management and their effect on the financial statements, such as fair-value accounting and related assumptions.
- Review new accounting and reporting requirements, and assess how pending financial reporting and regulatory developments may affect the organization.
- Discuss succession planning for the CFO and other key staff.

Oversight of Financial Reporting

- Oversee the adequacy of the entity's system of internal controls.
- Determine if the entity has adopted an internal control framework, such as the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework* (released May 14, 2013) and the Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government* (revised September 10, 2014) or "Green Book,"⁴ in the establishment of their system of internal control.
- Review the development and the implementation of a sub-certification process over internal control and compliance with related laws, regulations, or other requirements.

Oversight of the Independent Auditor

- Review the audit plan and the scope of audit to be conducted by the independent auditor.
- Provide pre-approval of all audits, permitted non-audit services, and proposed fees.
- Appoint or replace the independent auditor, including the periodic rotation of the audit partner.⁵
- Conduct evaluations of the independent auditor. Meet periodically with legal, IT, actuarial, and other specialists.

Oversight of the Internal Audit Function

- Approve the internal audit department charter.

⁴ The use of the COSO Framework is not a requirement in federal, state, or local government; though, using it is a best practice. The use of the GAO's Green Book, however, is a requirement for the federal government. Although not required in state and local government, using the Green Book is a best practice because it is specifically tailored to a government environment.

⁵ This may not apply if the independent auditor is mandated by law or regulation to perform audits for external purposes and may be overseen by an OIG or similar entity.

- Ensure that the internal audit department follows the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing, and maintains an effective quality assessment and improvement program.
- Concur in the appointment of the chief audit executive (CAE).⁶
- Review the internal audit department's planning and risk assessment process.
- Review and approve the internal audit department's annual (or periodic) audit plan and scope of audits to be conducted.
- Conduct evaluations of the chief audit executive.
- Ensure that the chief audit executive reports functionally to the audit committee and administratively to senior management such as the head of the governing body.
- Discuss succession planning for the CAE and other key staff.

Oversight of Risk Management

- Oversee the system of risk assessment and risk management as determined by the governing body. The audit committee should be focused primarily on financial risk. Compliance or regulatory risks as well as single audit and any other engagements performed by the external auditor may also be reviewed by the audit committee.
- Oversee and respond to enterprise risk management activities.
- Periodically reassess the list of top enterprise risks, determining who in the senior leadership team is responsible for each risk.

Oversight of Ethics and Compliance

- Oversee the system for compliance with legal and regulatory requirements (for example, OMB circulars, budgeting, HHS regulations, and the like).
- Ensure that management exhibits ethical behavior and reported violations receive action.
- Ensure that a code of conduct has been developed, reviewed, and updated as needed, and that all employees are given the code of conduct, understand it, and receive training on a regular basis.
- Ensure that a chief ethics and compliance officer or equivalent has been appointed and has sufficient personnel and resources commensurate with the entity's needs.
- Review the government entity's procedures for reporting problems, including whistleblower hotline and other communication methods.

⁶ This may not apply if the CAE is an elected official.

- Establish a process for audit committee special investigations, including but not limited to whistleblower allegation, anti-fraud plan compliance, discovery of error, and illegal acts.
- Ensure that the chief ethics and compliance officer or equivalent has direct access to the governing body or one of its committees (or similar bodies).

Limitation of Audit Committee's Role

While the audit committee's responsibilities are set forth in its charter, it is not responsible for planning or conducting audits. The independent auditor is responsible for planning and conducting audits. Neither is the audit committee responsible for (1) preparing and fairly presenting the government entity's financial statements in accordance with generally accepted accounting principles, (2) maintaining effective internal control over financial reporting, and (3) ensuring the government entity is in compliance with applicable laws, regulations, and other requirements. These responsibilities are management's, and the independent auditor and the audit committee have independent and complementary oversight responsibilities for determining that the related objectives of management's responsibilities, as described, are achieved.

Chapter 2: Audit Committee Charter Matrix

Overview: Preparing an audit committee charter is a best practice for government entities as it creates a clear awareness of the committee's key responsibilities. However, the charter is often prepared and forgotten except for its annual review. This matrix is designed to help audit committees make the charter a living document and use it to manage the agenda. This tool is meant as a sample. Users of the tool should put their own charters in the first column and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling. The audit committee charter presented in the first column of the following matrix is just an example of a best practice charter. It includes the requirements of the Sarbanes-Oxley Act of 2002 (the Act) and stock exchange requirements, which are not government requirements, but may want to be considered as a best practice.

Purpose

An entity's governing body appoints the audit committee to, among other things:

- a.* oversee the accounting and financial reporting process and the audit of the entity's financial statements by an independent auditor, and
- b.* monitor compliance with the conflict of interest policy and the whistleblower policy adopted by the governing body. Each member shall be free of any relationship that, in the opinion of the governing body, would interfere with his or her individual exercise of independent judgment.

Reporting

The audit committee reports directly to the governing body.

Committee Membership

The audit committee shall consist of no fewer than three members, each of whom should be independent, as hereafter defined. One member shall be designated as a financial expert.¹ The members of the audit committee shall be appointed annually by the governing body. Audit committee members may be replaced by the governing body at any time. The governing body shall designate the chairperson of the audit committee.

Committee Authority and Responsibilities

The audit committee shall meet as often as it determines necessary or appropriate to fulfill its responsibilities, but no fewer than twice annually—once to review the audit plan and once to review the audited financials, and related documents, and to review the audit engagement, special investigations, financial irregularities and internal control failures. The chairperson shall preside at each meeting and, in the absence of the chairperson, one of the other members of the audit committee shall be designated as the acting chair of the meeting. The chairperson (or acting chair) may direct appropriate members of management and staff to prepare draft agendas and related background information for each audit committee meeting. To the extent practical, any background materials, together with the agenda for the meeting, should be distributed to the audit committee members in advance of the meeting. All meetings of the audit committee shall be held pursuant to the laws or rules of the government entity with regard to notice and waiver thereof, and written minutes of each meeting, in the form approved by the audit committee, shall be duly filed in the entity's records. The audit committee shall make regular reports to the governing body. The audit committee may form and delegate authority to subcommittees consisting of one or more members when appropriate.

In performing its functions, the audit committee shall undertake those tasks and responsibilities that, in its judgment, would contribute most effectively to and implement the purposes of the audit committee. In addition to the general tasks and responsibilities noted above, the following are the specific functions of the audit committee:

- The audit committee shall annually retain or renew the appointment of an independent auditor to conduct the audit, and, upon completion, must review the results of the audit and any related management letter.

¹ A financial expert is a person who has the following attributes: (a) an understanding of generally accepted accounting principles and financial statements; (b) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (c) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (d) an understanding of internal controls and procedures for financial reporting; and (e) an understanding of audit committee functions.

- Review with the independent auditor the scope and planning of the audit prior to its commencement.
- Upon completion of the audit, review and discuss the following with the independent auditor:
 - Any material risks and weaknesses in internal controls identified by the independent auditor
 - Any restrictions placed on the independent auditor’s scope of the activities or access to requested information
 - Any significant disagreements between the independent auditor and management
 - The adequacy of the entity’s interim and annual accounting and financial reporting process
 - Any recommendations made
- Assess the performance and independence of the independent auditor on an annual basis.
- Solicit observations on staff skills, qualifications and performance related to audited functions.
- Report to the governing body on the committee’s activities, and recommend the results of audit findings for approval.
- Oversee corrective actions implemented to address issues identified in the required communication and management letter.

Additional Responsibilities

- Review audit plans for the upcoming year and discuss with external audit firm and internal audit.
- Monitor compliance with the conflict of interest policy and the whistleblower policy adopted by the entire governing body, as such policies may be modified from time to time and which reflect any changes made in state law from time to time. Act as external point of contact for any whistleblowing issues, and if necessary, initiate special investigations of policies, procedures and practices.
- Conduct executive sessions at least annually with the individual conducting the internal audit function (generally the CAE) and management.
- Review presentation of financial information in the annual report for consistency with the audited financial statements before the annual report is printed.
- Review with management and internal audit the internal control process, and risk management and mitigation process.

- Periodically review audit-related policies.

Definitions

Affiliate. An affiliate of the government entity is a person or entity that is directly or indirectly through one or more intermediaries, controlled by, in control of, or under common control of the government entity.

Financial Interest. A person has a financial interest if such person would receive, directly or indirectly, an economic benefit from any transaction, agreement, compensation agreement involving the entity including:

- Having an ownership or investment interest in any entity with which the government entity has a transaction or arrangement.
- Having a compensation arrangement with the entity or with any organization or individual with which the entity has a transaction or arrangement, including direct and indirect remuneration as well as gifts or favors that are substantial in nature (inexpensive gifts or services that have a retail value of no more than \$10 individually, and no more than \$50 in the aggregate annually are not considered “substantial”) or a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the entity is negotiating a transaction or arrangement.
- Accepting payments, loans, services or gifts from anyone doing or seeking to do business with the entity.
- Is an officer or director of any organization doing or seeking to do business with the entity.

Independent Governing Body Member. A member of the governing body that is not, and has not within the last three years been, (a) an employee of the entity or any affiliate, and does not have a relative who is or has been within the last three years a key employee of the entity or any affiliate; (b) an individual who has received or has a relative who received (more than \$10,000 in direct compensation from the entity or any affiliate within any of the last three fiscal years (other than reimbursement of reasonable expenses or reasonable compensation for serving as a director); or (c) an employee of, or an individual who has a substantial financial interest in, any entity that has made payments to or received payments from the entity or an affiliate for property or services (which, in any of the last three fiscal years, exceeds the lesser of \$25,000 or 2 percent of such entity's consolidated gross revenues) and does not have a relative who is an officer of or has a substantial financial interest in any such entity.

Key Employee. Any person who is, or has within the last five years been, in a position to exercise substantial influence over the affairs of the entity including, without limitation, any employee with responsibilities similar to those of any person designated as president, chief executive officer, chief operating officer, treasurer, or chief financial officer.

Government Audit Committee Charter Matrix for the Year Ending: _____

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>1. Each member of the audit committee shall be appointed by the governing body and shall be independent in order to serve on this committee. (Note that this is a best practice and not a requirement for governments.)</p>	<p>Test for independence.</p> <p>Although a best practice, the independence requirement does not apply to governments.</p>	<p>Indicate in the audit committee minutes whenever a new member is appointed; acknowledge that independence has been verified.</p>	<p>Affirm annually and whenever a change in status by any audit committee member occurs.</p>	
<p>2. At least one member of the audit committee shall be designated as a <i>financial expert</i>.</p> <p>(See chapter 3, “Audit Committee Financial Expert Considerations and Decision Tree,” in this toolkit.)</p>	<p>Ascertain that at least one member of the audit committee meets the requirements of a financial expert.</p> <p>Although a best practice, the independence requirement does not apply to governments.</p>	<p>Indicate in audit committee meeting minutes which member of the audit committee is designated as the financial expert.</p>	<p>Affirm annually, unless there is a change in status.</p>	
<p>3. Review the audit committee’s charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the governing body. Consider</p>	<p>Review the charter each year. Assess the appropriateness of each point in the charter in light of the previous years’</p>	<p>Report to the governing body on the appropriateness of the audit committee charter</p>	<p>Review annually, unless changes are needed during the course of the year.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>changes that are necessary as a result of new laws or regulations.</p>	<p>experience. Assess the completeness of the charter in light of new best practices and new legal or regulatory requirements.</p>	<p>and any revisions recommended.</p>		
<p>4. The audit committee shall meet as deemed appropriate, but at least twice per year, as well as each time the government entity proposes to issue a press release with its quarterly or annual earnings information. These meetings may be combined with regularly scheduled meetings, or more frequently as circumstances may require. The audit committee may ask members of management or others to attend the meetings and provide pertinent information as necessary.</p>	<p>In-person meetings should be held at least once each quarter. All members are expected to attend each meeting in person, or via telephone conference or videoconference.</p> <p>Telephone conference meetings may be held more frequently.</p> <p>The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.</p>	<p>Prepare minutes that document decisions made and action steps following meetings and review for approval.</p> <p>Meeting minutes should be filed with the governing body.</p>	<p>Minutes should be distributed as soon as possible but no later than prior to the next meeting.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
5. Conduct executive sessions with the independent auditors, government entity head, chief audit executive (CAE), general counsel, chief information officer (CIO) and anyone else as desired by the committee.	Establish these sessions in conjunction with quarterly meetings or as necessary. (See chapter 12, “Guidelines and Questions for Conducting an Audit Committee Executive Session,” in this toolkit.)	Develop action steps to be taken if appropriate.	Review quarterly and as necessary.	
6. The audit committee shall be authorized to hire outside counsel or other consultants as necessary. This may take place any time during the year. (See chapter 7, “Engaging Independent Counsel and Other Advisers,” in this toolkit.)	Requests for proposals (RFPs) should be used, if time permits.	Report submitted by outside counsel or consultant.	Review as needed.	
7. Review and concur in the appointment, replacement, reassignment, or dismissal of the CAE.	Meet in executive session at each meeting with the CAE to allow assessment and feedback. Hold special meetings as may be necessary to	Report to the full governing body on the performance of the CAE, including the effectiveness of the internal audit function.	Conduct ongoing reviews, as changes can be made at any time during the year.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>(See chapter 6, “Guidelines for Hiring the Chief Audit Executive (CAE),” in this toolkit.)</p>	<p>address appointment, reassignment, or dismissal of CAE.</p> <p>The audit committee chair should be available if any unforeseen issues arise between meetings relating to the CAE.</p> <p>Meet at least once annually with other members of executive management and the independent auditors to discuss the performance of the CAE.</p> <p>Discuss job satisfaction and other employment issues with the CAE.</p>			
<p>8. Appoint the independent auditors to be engaged by the government entity, establish the audit fees of the independent auditors, and pre-approve any non-audit services provided by the independent</p>	<p>At least once each year, discuss each of these items with management, the CAE, and the governing body.</p> <p>Review total audit fee in relation to any non-audit</p>	<p>Report on and recommend the performance and fees paid to the independent auditors. Review the scope of <i>all</i> services provided by the</p>	<p>Review soon after year-end, so that the recommendation for the appointment of the independent auditor can be met for the following year.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>auditors before the services are rendered.</p> <p>Review and evaluate the performance of the independent auditors and review with the full governing body any proposed discharge of the independent auditors.</p> <p>(See the tools and guidance in chapter 4, “Sample Request for Proposal Letter for CPA Services (Government),” in this toolkit.)</p>	<p>services being provided by the independent auditor.</p> <p>Discuss the audit committee’s review of the independent auditors with the governing body.</p> <p>Ascertain that the independent auditors do not perform any non-audit service that is prohibited by generally accepted auditing standards or <i>Generally Accepted Government Auditing Standards</i> (the “Yellow Book”). Consider establishing pre-defined acceptable services the independent auditor may engage in based upon regulations.</p>	<p>independent audit firm throughout the entity.</p>		
<p>9. Ascertain that the lead (or concurring) independent audit partner does not serve in that</p>	<p>Establish when the five-year limit will be reached for the current lead</p>	<p>Document these discussions in audit</p>	<p>Review annually with the independent auditors.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>capacity for more than five of the government entity’s fiscal years (best practice). In addition, ascertain that any partner other than the lead or concurring partner does not serve more than seven years at the partner level on the government entity’s audit committee.</p>	<p>independent audit partner. At least a year prior to that time, discuss transition plans for the new lead independent audit partner.</p> <p>Although a best practice, the partner rotation requirements do not apply to government entities.</p>	<p>committee meeting minutes.</p>		
<p>10. Review with management the policies and procedures with respect to officers’ expense accounts and perquisites, including their use of government assets, and consider the results of any review of these areas by the internal auditor or the independent auditors.</p>	<p>Review policies and procedures annually. Discuss with the CAE the need for testing by either the internal auditors, independent auditors, or other parties.</p>	<p>Report issues, if any, to the governing body.</p>	<p>Review policies and procedures at a regularly scheduled meeting, and discuss audit plan.</p> <p>Review any significant findings as they arise.</p>	
<p>11. Consider with management the rationale for employing audit firms and other outside specialists</p>	<p>Establish a policy for the audit committee to pre-approve engaging auditors</p>	<p>Document auditor selection criteria. Also, use a decision matrix to</p>	<p>Continually review the policy and the government entity’s compliance with it.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>other than the principal independent auditors.</p>	<p>other than the principal independent auditors.</p> <p>Use RFPs for engaging auditors or other professionals for non-audit or other services that the independent auditor cannot perform.</p> <p>Review compliance with the policy by management.</p> <p>(See chapter 4, “Sample Request for Proposal Letter for CPA Services and Qualifications (Government Entity),” in this toolkit.)</p>	<p>evaluate and document the third party selection.</p> <p>Prepare an engagement letter for each engagement.</p>	<p>Other auditors may need to be hired at any point during the year.</p>	
<p>12. Make inquiries to management, the CAE, and the independent auditors about significant risks or exposures facing the government entity; assess the steps management has taken or proposes to take to minimize such risks to the entity; and</p>	<p>Create a portfolio that documents the material risks that the entity faces in developing an enterprise risk management strategy. Update as events occur. Review with management and the CAE quarterly or</p>	<p>Submit a risk report including mitigation strategies, quantifiable risks, and insurance to cover risks such as property loss or fraud.</p>	<p>Review at least once each year, and more frequently if necessary.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>periodically review compliance with such steps.</p> <p>(See the tools and guidance included in chapter 8, “Internal Control: Guidelines and Tool for the Audit Committee,” chapter 9, “Fraud and the Responsibilities of the Audit Committee: An Overview,” and chapter 19, “Enterprise Risk Management: A Tool for Strategic Oversight,” in this toolkit.)</p>	<p>sooner if necessary, to make sure it is up to date.</p>			
<p>13. Review the audit scope and plan of the internal auditors and the independent auditors with the independent auditor, the controller of the government entity, and the CAE. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.</p>	<p>Meet with the independent audit partner, the controller, and CAE to discuss the scope of the previous year’s audit and lessons learned. Later, discuss planned scope for audit of current year.</p>	<p>Document the meeting in the audit committee meeting minutes.</p>	<p>At the second quarter meeting each year, review the scope of the previous year’s audit, and the inter-relationship between the internal and independent auditors with respect to the scope of the independent auditors’ work.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
			No later than the third quarter meeting each year, review the plans for the audit of the current year.	
<p>14. Review with management and the CAE</p> <ul style="list-style-type: none"> • significant findings on internal audits during the year, and management’s responses thereto. • any difficulties the internal audit team encountered in the course of their audits, including any restrictions on the scope of their work or access to required information. • any changes required in the scope of their internal audit. • the internal auditing department budget and staffing. • the internal auditing department charter. 	<p>Review and discuss the findings for each audit completed since the prior meeting, and management’s response to the report.</p> <p>Discuss internal audit department budget and staffing with CAE.</p> <p>Discuss internal audit’s compliance with the Institute of Internal Auditors’ (IIA) standards, including the requirement for a peer review once every five years.</p>			

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<ul style="list-style-type: none"> internal auditing’s compliance with IIA’s Standards for the Professional Practice of Internal Auditing (standards). 				
<p>15. Inquire of the government entity head, CFO, independent auditor, CIO, general counsel, and anyone else desired by the audit committee, regarding the <i>financial condition</i> of the government entity from a subjective as well as an objective standpoint.</p>	<p>Discuss <i>financial condition</i> with the government entity head, CFO, CIO, independent auditor, general counsel, and other executives. Identify any issues addressed, and their resolution.</p>	<p>Include in agenda for executive sessions. (See chapter 12, “Guidelines and Questions for Conducting an Audit Committee Executive Session,” in this toolkit.)</p>	<p>Review, as necessary, but at least annually.</p>	
<p>16. Review with the independent accountants and the CAE</p> <ul style="list-style-type: none"> the adequacy of the government entity’s internal controls including computerized information system controls and security. any related significant findings and recommendations of the independent auditors and 	<p>Review key internal controls with the CAE, and understand how these controls will be tested during the year.</p> <p>Review these plans with the independent auditor to understand their scope with respect to key controls.</p>	<p>Report to the governing body on issues relating to internal controls, with emphasis on management’s ability to override and related monitoring and testing.</p>	<p>Submit a comprehensive report to the governing body at the second quarter meeting each year.</p> <p>Update on anything new, or any changes to the internal control system, at every meeting.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>internal audit services together with management's responses thereto.</p> <p>(See the tools and guidance included in chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," chapter 9, "Fraud and the Responsibilities of the Audit Committee: An Overview," and chapter 14, "Responding to the Identification of a Material Weakness in Internal Control: A Checklist for the Audit Committee," in this toolkit.)</p>	<p>Review with the CAE the plans for audits of other elements of the control environment.</p> <p>Determine that all internal control weaknesses are quantified, reviewed, and addressed.</p>			
<p>17. Review with management and the independent auditor the effect of any new regulatory and accounting initiatives.</p>	<p>Independently, through professional reading and CPE, keep up to date on new developments related to the industry, and the environment in which the government entity operates, including any regulatory or statutory</p>	<p>Record discussion and any action steps in audit committee meeting minutes.</p>	<p>Review as necessary.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
	<p>requirements to which it may be subject.</p> <p>Discuss with management and the independent auditors in meetings.</p>			
<p>18. Review with each public accounting firm that performs an audit</p> <ul style="list-style-type: none"> all critical accounting policies and practices used by the government entity. all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the government entity, the ramifications of each alternative, and the treatment preferred by the organization. <p>(See the tool in chapter 11, “Issues Report from Management,” in this toolkit.)</p>	<p>Discuss each matter and related matters that may come to the attention of the audit committee or the independent auditors through this process.</p> <p>Create an action plan and follow-up plan as necessary.</p>	<p>Submit reports and documentation of discussions and resolution of disagreements.</p>	<p>Review, at least annually, and in conjunction with the year-end audit.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>19. Review all material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.</p>	<p>Discuss each item with the independent auditors and management, including the CAE, and conclude on the appropriateness of the proposed resolution.</p>	<p>Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow up and monitoring.</p>	<p>Review at the completion of the independent audit.</p>	
<p>20. Review with management and the independent auditors</p> <ul style="list-style-type: none"> • the government entity’s annual financial statements and related footnotes. • the independent auditors’ audit of the financial statements and their report thereon. • the independent auditors’ judgments about the quality, not just the acceptability, of the entity’s accounting principles as applied in its financial reporting. 	<p>Discuss each matter, and others that may come to the attention of the audit committee through this process, with management (including the CAE) and the independent auditors.</p> <p>Review with management the course of action to be taken for any action requiring follow up.</p> <p>Monitor any follow-up action that requires continued audit committee intervention.</p> <p>(See the tool in chapter 13, “Independent Auditor</p>	<p>Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow up.</p>	<p>Review at the completion of the independent audit.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<ul style="list-style-type: none"> any significant changes required in the independent auditors’ audit plan. any serious difficulties or disputes with management encountered during the audit. matters required to be discussed by AU-C section 260, <i>The Auditor’s Communication With Those Charged with Governance</i> (AICPA, <i>Professional Standards</i>), as amended, related to the conduct of the audit. 	<p>Communications with Audit Committee,” in this toolkit.)</p>			
<p>21. Review with the general counsel and the CAE legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related government entity compliance policies, and programs and reports received from regulators.</p>	<p>Discuss whether the government entity is in compliance with laws and regulations.</p>	<p>Report to the governing body that the review has taken place and any matters that need to be brought to its attention.</p>	<p>Review at each meeting.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
<p>22. Periodically review the government entity code of conduct to ensure that it is adequate and up to date.</p> <p>Review with the CAE and the government entity's general counsel the results of their review of the monitoring of compliance with the entity's code of conduct.</p>	<p>Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the government entity's code of conduct.</p> <p>Consider steps that may need to be taken to ensure that compliance is at the highest possible level.</p>	<p>Report to the governing body that the review of the code of conduct was done.</p> <p>Recommend changes to the code of conduct to the governing body as needed.</p>	<p>Review annually at the fourth-quarter meeting.</p> <p>Review any significant findings as they arise.</p>	
<p>23. Review the policy and procedures for the receipt, retention, and treatment of complaints received by the government entity regarding illegal or unethical behavior, violations of law, regulation, rule or policy of the entity, accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the entity.</p> <p>Review any such complaints that might have been received, current</p>	<p>Review procedures with the CAE or other assigned appropriate person and the general counsel.</p> <p>Review all complaints that have been received and the status of resolution.</p> <p>Ensure that proper steps are taken to investigate complaints and resolve timely.</p> <p>(See also the tool in chapter 10, "Whistleblower</p>	<p>Review an original of each complaint received, no matter the media used to submit. Discuss the status or resolution of each complaint.</p> <p>Review a cumulative list of complaints submitted to date to review for patterns or other observations.</p>	<p>Review at each meeting.</p>	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
status, and resolution, if one has been reached.	Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report,” in this toolkit.)			
24. The audit committee will perform other functions as assigned by law, the government entity’s charter or bylaws, or the governing body.	Monitor developments in the regulatory, legislative, and legal environments, and respond to any new requirements as needed.		Review new business at all meetings.	
25. The audit committee will evaluate the independent auditors and internal auditors.	<p>Use information from executive sessions conducted throughout the year.</p> <p>Use a formal assessment tool for each group.</p> <p>(See the tools and guidance in chapter 15, “Evaluating the Internal Audit Function: Questions to Consider,” and chapter 16, “Evaluating the Independent Auditor:</p>	Submit recommendations for changes in process and procedures. For independent auditors, request RFPs, if changes are being considered.	Review after completion of the annual audit.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
	Questions to Consider” in this toolkit.)			
26. The audit committee will review its effectiveness.	<p>The audit committee will conduct a self-assessment and 360-degree evaluation of all members.</p> <p>(See the tools and guidance in chapter 17, “Conducting an Audit Committee Self-Evaluation: Questions to Consider,” in this toolkit.)</p>	<p>Discuss recommendations for improving the effectiveness of the audit committee with the governing body.</p> <p>Record in the governing body’s meeting minutes.</p>	Review annually.	
27. Create an audit committee calendar for the ensuing year or review and approve the agenda submitted by the CAE.	Complete the “Audit Committee Charter Matrix.” (Use this tool as a sample and tailor it to your organization.)		Review at the final meeting before the upcoming year.	

Chapter 3: Audit Committee Financial Expert Decision Tree

Overview: Although there is no explicit requirement for a government audit committee to include a member having some level of financial expertise, it is considered a best practice. In addition, it should be the goal of the government entity's audit committee that all its members have some level of experience in financial matters and an understanding of the entity's mission, programs, and the sector in which it operates. Following are guidelines for evaluating audit committee members and a decision tree that illustrates how the audit committee might evaluate a candidate for consideration as a financial expert. These are recommended in providing best governance practice in this area.

Audit Committee Financial Expertise

The following attributes are all deemed to be typical components of financial expertise:

- An understanding of generally accepted accounting principles, generally accepted auditing standards, and financial statements
- The ability to assess the general application of such principles and standards in connection with the accounting for estimates, accruals, and reserves
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the government entity's financial statements or experience actively supervising (that is, direct involvement with) one or more people engaged in such activities
- An understanding of internal controls and procedures for financial reporting
- An understanding of audit committee functions (roles and responsibilities)
- A general understanding of the financial issues and specific knowledge of the government sector (for example, federal, state, or local government)
- A general knowledge of any current relative concerns or regulatory issues surrounding the government entity's specific sector
- An understanding of the past 3–5 years of the government entity's financial history

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The following questions may be used to assess whether an individual audit committee member, or the committee as a whole, possesses the preceding attributes:

- Do laws or regulations governing the government entity include certain requirements of audit committees regarding independence, oversight (i.e. the criteria for the government entity's audit), governance, committee activities, or other criteria?
- Have one or more individuals completed a program of learning in accounting or auditing?
- Do one or more individuals have experience as a chief or principal financial officer (for example, finance director or business manager), principal accounting officer, controller, public accountant, or auditor?
- Do one or more individuals have experience with government accounting standards?
- Do one or more individuals have experience in position(s) that involve the performance of similar functions?
- Have one or more individuals gained experience by actively supervising a person or people performing one or more of these functions?
- Do one or more individuals have experience overseeing or assessing the performance of companies, or public accountants with respect to the preparation, auditing, or evaluation of financial statements?
- Do one or more individuals have other relevant financial experience (for example, service on boards of not-for-profits, health care entities, higher education institutions, etc.)?
- Do one or more individuals have experience serving on audit committees of other government entities?

Alternative Approaches

Based on the public awareness and environment surrounding the government sector, best practice should include that some (at a minimum), if not all, members of an entity's audit committee possess an adequate level of government financial knowledge and expertise. This may need to be accomplished by recruiting new independent board members.

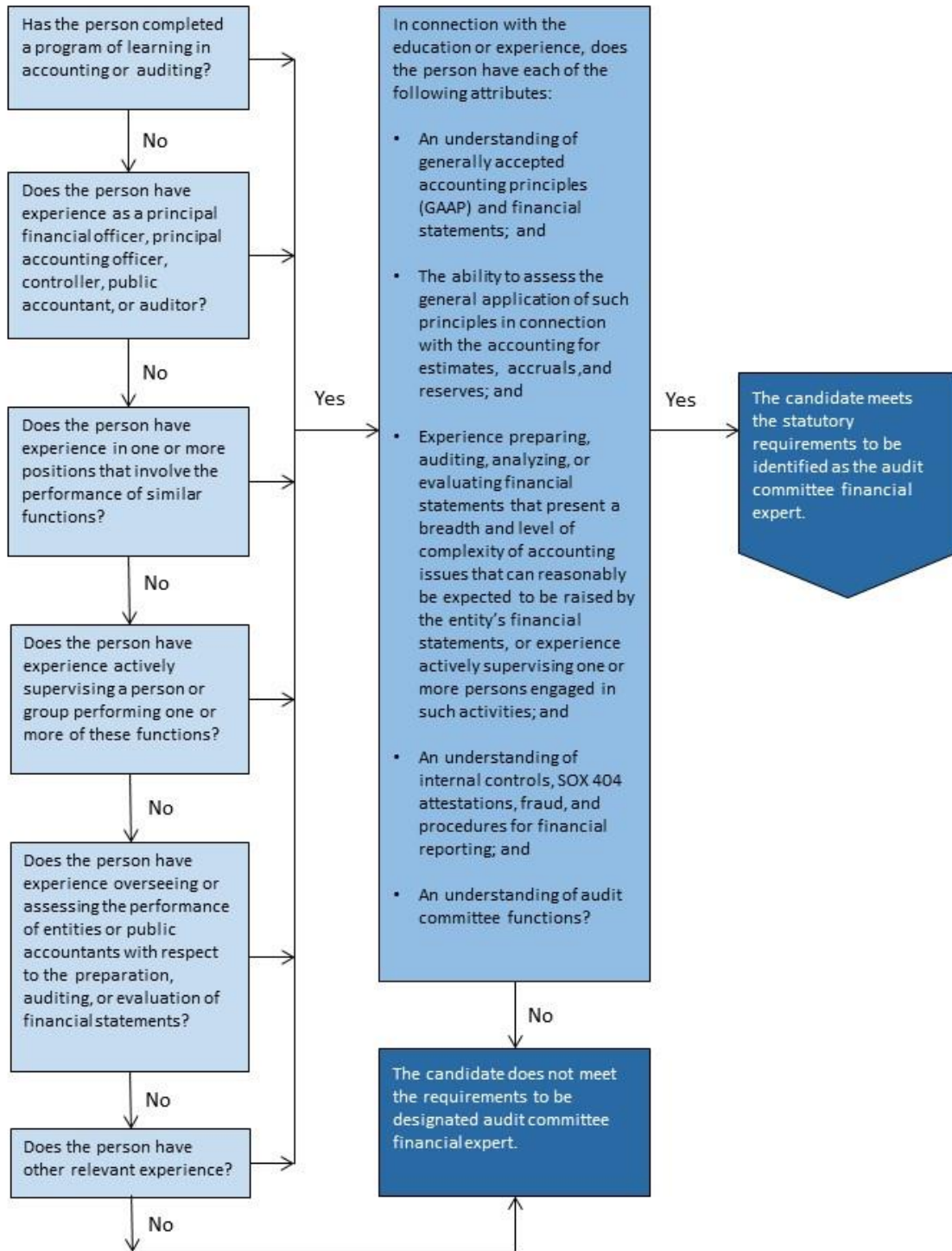
However, if no individual member of the audit committee possesses the attributes required for financial expertise, and the committee members collectively do not possess such attributes, two options might be considered:

- Engage a financial professional to provide financial expertise as a consultant to the audit committee. Such an individual must otherwise be independent with respect to the entity (that is, must have no other financial arrangements with the government entity).
- Pursue a training program for audit committee members to develop the financial expertise. Such training can include participation in professional development classes or programs offered by the AICPA, associations, or the specific sector in which the

government entity participates, or in-house training programs led by members of the government entity's financial management team.

- Potential volunteers with financial expertise often have limited time to commit to an entity. They might, for example, have time to attend one or two meetings per year, but not monthly board meetings. Therefore, it may be beneficial, if bylaws allow it, to open up membership of the audit committee to persons who are not also members of the board of directors or trustees. This can be particularly helpful for smaller government entities.
- Establish a relationship with a peer or otherwise comparable government entity to have the CFO for one entity provide financial expertise to the other. Such arrangements can be reciprocal or involve multiple entities.

Audit Committee Financial Expert



Chapter 4: Sample Request for Proposal Letter for Independent Auditor¹ Services and Qualifications (Government Entity)

Overview: This tool contains sample language that may be used by a government entity's management team to request proposal letters from qualified independent auditors when seeking a new service provider. As such, the sample letter may be subject to audit committee review or discussion. Separate requests for proposal (RFPs) could be used for audit services and any additional services (for example, compilations or consulting engagements).

Additional useful information in the RFP process is included in chapter 5, "AICPA Peer Reviews and PCAOB Inspections of CPA Firms: An Overview," and chapter 17, "Evaluating the Independent Auditor: Questions to Consider," in this toolkit. Consideration of the information included in these sections is critical to successfully evaluating the RFP process.

Because the RFPs may require significant time investments from both the government entity, to prepare them, and the independent auditor, to respond fully, the government entity may first want to send requests for qualifications to determine the most qualified independent auditors from which to request RFPs.

Audit committees may wish to review the following AICPA Practice Aid and guidance that provides helpful information in planning, developing the request for proposal, and evaluating the proposals received:

- Procuring Governmental Audit Services. This document is available at: <http://www.aicpa.org/interestareas/governmentauditquality/resources/auditeeresourcecenter/downloadabledocuments/rfppracticeaid.pdf>.
- Why Audit Quality is Important for Auditees? This document is available at: <http://www.aicpa.org/interestareas/governmentauditquality/resources/auditeeresourcecenter/pages/whyauditqualityisimportantforauditees.aspx>

¹Independent auditors in a government entity may be required to complete and report on certain audits as a consequence of constitutional or statutory requirements over which the auditor has no control. In other jurisdictions, auditors in a government entity may compete with other independent auditors for audit services.

[Government Entity Letterhead]

[Current Date]

[Managing Partner and/or Government Audit Organization Director]

[CPA Firm and/or Government Audit Organization]

[Street Address]

[City, State, Zip]

Dear Sir or Madam:

Our organization is accepting proposals from independent auditors to provide an audit for our government entity in the fiscal year X ending *[date]*. We invite your independent audit organization to submit a proposal to us by *[date]* for consideration. Note that the audit committee of the government entity's governing body (audit committee) is generally the decision-maker in the hiring of the government entity's auditor.² The government entity is acting at the direction of the audit committee in sending this request for proposal (RFP) to you. A description of the government entity, the services needed, and other pertinent information follow.

Background of X Government Entity

X Government Entity is a department within the State of Y, which is responsible for providing *[specified]* services to citizens of the State. Appropriations for this component unit are between \$250 million and \$350 million annually, and the government entity employs 1,575 employees in 5 locations. The government entity also receives \$200 million in grant funds from the federal government. Because the government entity receives over \$750,000 in federal grant funds, the audit is subject to the requirements of the Single Audit Act of 1996 and OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations (Circular A-133). This Act and the Circular require the audit be conducted in accordance with *Government Auditing Standards*. The government entity has a June 30 fiscal year-end, with a requirement to file an audited financial statement with the Federal Audit Clearinghouse by March 31 of the following year. Because the government entity usually submits its report for the Government Finance Officers Association (GFOA) Certificate of Achievement for Excellence in Financial Reporting (CAFR Program), the report and financial statements need to be submitted to GFOA by December 31 of each year.

Services to Be Performed

Your proposal is expected to cover the following services:

1. Annual audit to be completed in accordance with aforementioned legal and regulatory requirements, filing requirement(s), and meetings with audit committee as necessary
2. Quarterly reviews of internally prepared interim financial statements

² See footnote 1.

3. Auditor evaluation of and reporting on the internal control over financial reporting, as required by state statute
4. Attendance at and reporting to the audit committee twice each year

Key Personnel

Following is a list of key persons you may wish to contact with respect to this engagement:

Mr. Green	[Head of X government entity]	1-123/555-7890
Ms. Brown	CFO	1-123/555-7891
Mr. Black	General Counsel	1-123/555-7892
Mr. White	Controller	1-123/555-7893
Mr. Plain	[Position responsible for overseeing the strategic direction of the entity]	1-123/555-4567
Ms. Trane	Audit Comm. Chair	1-456/555-0123

For control purposes, we ask that you coordinate requests for additional information, visits to our site, review of prior financial statements, and/or appointments with the Head of X, CFO, and Audit Committee Chair through our controller, Mr. White.

Relationship With Prior Independent Auditor

Because the audit requirement for X government entity was established over 20 years ago, these services have been provided by XYZ independent auditors. However, that audit organization is no longer able to provide the services to our X government entity. In preparing your proposal, be advised that management will give you permission to contact the prior auditors.

You may use this section to disclose whether the decision to change auditors is a function of changes in the government entity, changes in the independent audit organization, or result of a period review of your satisfaction with the services provided. You may describe other aspects of your relationship with the prior auditor that you are willing to disclose at this stage in the proposal process here. Independent auditors may request additional information, which you may choose to disclose only if the requesting independent auditor signs a nondisclosure agreement.

Other Information

Use this space to discuss other information that an independent audit organization may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned earlier, you should only disclose information here that you are comfortable disclosing; additional information may be available to the independent audit organization interested in making serious proposals only after signing a nondisclosure agreement.

Your Response to This Request for Proposal

In responding to this request, please provide the following information:

These are sample questions that you may consider asking. You should tailor these questions to your circumstances, and delete or add additional questions as appropriate.

Background on the Independent Auditor

1. Detail your independent auditor's experience in providing auditing services to government entities, as well as associations of a comparable size to X government entity.
2. Provide information on whether you provide services to any related government entities.
3. Discuss the independent auditor's independence with respect to X government entity.³
4. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last three years.
5. Identify the five largest government entity clients your independent auditor has lost in the past three years and the reasons. Also, discuss instances when loss of the government entity client was due to an unresolved auditing or accounting matter. Explain your strategies to resolve the issue(s).
6. Identify the partner, manager, and in-charge accountant (or equivalent positions if the independent auditor is within the government) who will be assigned to this audit if you are successful in your bid, and provide biographies for these individuals. Indicate any complaints that have been leveled against them by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the independent auditor with respect to these individuals.

³*Government Auditing Standards* should be used as criteria for determining independence if the audit is required to be performed in accordance with the Single Audit Act, or other audit requirement that mandates the use of *Government Auditing Standards*.

7. Describe how your independent auditor will approach the audit of the government entity, including the use of any association or affiliate member firm personnel and the areas that will receive primary emphasis. Also, discuss the independent auditor's use of technology in the audit. Finally, discuss the communication process used by the firm to discuss issues with the management and audit committees.
8. If the audit is reimbursable, furnish current standard billing rates for classes of professional personnel for each of the last three years, including an expense policy describing how incidental costs (for example, travel and mileage) are billed.
9. If professional advice is reimbursable, describe how you bill for questions on technical matters that may arise throughout the year.
10. Provide the names and contact information of at least two to three other government entity clients of a similar size and level of the partner and manager who will be assigned to our government entity.
11. Describe how and why your independent auditor is different from other independent auditors being considered, and why our selection of your audit organization as our independent auditors is the best decision we could make.
12. Describe how your independent auditor will prioritize the work you do for X government entity.
13. Include a copy of your audit organization's most recent Peer Review report, any separate written communication explaining deficiencies or significant deficiencies noted in the peer review, and any audit organization's response to any deficiencies reported, either in the peer review report or in a separate written communication.
14. Describe the independent auditor's approach to the resolution of technical disagreements (*a*) among engagement personnel, and (*b*) between the independent auditor and the government entity client.
15. Explain how you monitor and maintain your independence on an ongoing basis.
16. Finally, please submit information on the independent auditor's liability insurance coverage.

Experience in Our Industry

Use this space to ask questions about the independent auditor's experience providing services to other government entity clients, as well as providing services to entities within the similar level of government.

Expected Approach to This Audit as Also Noted Previously

1. Identify the partner, manager, and in-charge accountant (or equivalent positions if the independent auditor is within the government entity) who will be assigned to this audit if you are successful in your bid, and provide biographical material for each. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the independent audit organization with respect to these people.
2. Describe how your independent audit organization will approach the audit of the organization, including the use of any association or affiliate member audit organization personnel.
3. If the audit is reimbursable, set forth your fee proposal for the 20XX audit with whatever guarantees you offer regarding fee increases in future years. Provide your proposed fee for the quarterly review work that will be required. Ensure that the fee as proposed is sufficient to cover the work that you expect to perform if you are awarded this audit.

Evaluation of Proposals

The Audit Committee of the X government entity will evaluate proposals on a qualitative basis. This includes a review of the independent audit organization's peer review and related materials, interviews with senior engagement personnel to be assigned to our government entity, results of discussions with other government clients, and the independent auditor's completeness and timeliness in its response to us. Finally, please submit information on the independent auditor's liability insurance coverage.

If you choose to respond to this request, please do so by [*Date indicated earlier in the letter*]. Please let us know if you choose not to respond to this RFP.

Sincerely,

Ms. Brown, CPA
Chief Financial Officer

Ms. Trane
Chair
Audit Committee

Chapter 5: AICPA Peer Reviews and PCAOB Inspections of CPA Firms: An Overview

Overview: The tool in this chapter is designed to educate audit committee members about the AICPA practice-monitoring programs (also known as peer review) over the accounting and auditing practices of the majority of U.S. CPA firms. This chapter is also intended to assist audit committee members in understanding the obligations and oversight of CPA firms. In addition, CPA firms that audit public companies regulated by the U.S. Securities and Exchange Commission (SEC) are subject to periodic inspections by the Public Company Accounting Oversight Board (PCAOB). See the section “Public Company Accounting Oversight Board Inspection” of this tool for a discussion of PCAOB inspection and related questions for the audit committee. While this toolkit is focused on government entities, the audit committee can still gain insight from a CPA firm’s PCAOB report. It is important to note that the AICPA Peer Review Programs and the PCAOB Inspection Program are not substitutes for each other.

Peer Review of a CPA Firm

This chapter is intended to help audit committee members understand the purpose of a CPA firm’s peer review and the importance of the review’s results to the audit committee, and how to interact with the firm concerning its peer review. A peer review is required of a CPA firm by the AICPA as a member, by most state boards of accountancy, and by generally accepted government auditing standards if a CPA firm audits government entities or entities that receive government awards.

A peer review of a CPA firm can be used by an audit committee as a tool to assess whether the CPA firm it hires or is considering hiring

1. has a system of quality control for its accounting and auditing practice that has been designed to meet the requirements of the AICPA’s Statements on Quality Control Standards (SQCSs), and
2. is complying with that system of quality control during the peer review period to provide the firm with reasonable assurance of complying with professional standards.

Peer reviews only include an evaluation of the CPA firm’s non-SEC practice. The CPA firm’s SEC practice is covered by a PCAOB inspection discussed in detail in the section “Public Company Accounting Oversight Board Inspection” later in this chapter.

The AICPA’s standards regarding a system of quality control provide requirements in the areas of auditor independence, integrity, and objectivity; audit personnel management; acceptance and continuance of audit clients and engagements; audit engagement performance; and firm quality control monitoring. Professional standards are literature, issued by various organizations, that contain the framework and rules that a CPA firm is expected to comply with when designing its system of quality control and in performing its work.

A CPA firm (reviewed) will engage another (reviewing) CPA firm to perform the peer review. However, the reviewing CPA firm must be independent of the reviewed CPA firm, qualified to perform the review, and approved by the administering entity to perform the review. The administering entity is the independent body responsible for administering, evaluating, and accepting peer reviews, and includes its peer review committee). For many CPA firms, the National Peer Review committee or State CPA Societies administer the peer reviews depending on whether the CPA firm audits SEC companies.

Peer Review Reports

The reviewed CPA firm may receive one of three types of peer review report ratings: *pass*, *pass with deficiencies*, or *fail*.

1. A *pass* report should be issued when it is concluded that the firm's system of quality control for the accounting and auditing practice has been suitably designed and was complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
2. A report rating of *pass with deficiencies* should be issued when the firm's system of quality control for the accounting and auditing practice has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting with applicable professional standards in all material respects with the exception of a certain deficiency or deficiencies that are described in the report.
3. A report with a peer review rating of *fail* should be issued when significant deficiencies exist and the firm's system of quality control is not suitably designed to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects, or the firm has not complied with its system of quality control to provide reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

If deficiencies are found, a peer review report rating of *pass with deficiencies* or *fail* is used and the reviewed CPA firm is expected to identify and take corrective measures to prevent the same or similar types of deficiencies from occurring in the future. Such measures could include making appropriate changes in the firm's system of quality control or having personnel attend training in specific areas. These measures should be described in a letter addressed to the administering entity, responding to the deficiencies or significant deficiencies and related recommendations identified in the report. In reviewing the CPA firm's response to the deficiencies noted in the peer review report, the administering entity may ask the firm to agree to certain other actions (referred to as "corrective actions") it deems appropriate in the circumstances, such as the submission of a monitoring report, a revisit by the reviewer, or joining an applicable audit quality center.

If during the peer review the reviewing CPA firm finds a matter that does not rise to the level of a deficiency, resulting in the reviewed CPA firm receiving a peer review report rating of *pass with deficiencies* or *fail*, the reviewer will complete a Finding for Further Consideration (FFC) form. The reviewing CPA firm will make a recommendation to the reviewed CPA firm to correct the finding for which the reviewed CPA firm will be asked to respond. The administering entity

will evaluate whether the reviewed CPA firm's responses to those recommendations appear comprehensive, reasonable, and feasible. The administering entity will determine if a finding should require an implementation plan from the reviewed CPA firm in addition to the plan described in its response to the findings on the FFC form.

We recommend that the audit committee request a copy of the CPA firm's most recently accepted peer review report and discuss the results with the firm. If the CPA firm received a peer review report rating of *pass with deficiencies* or *fail*, the audit committee should discuss the results and corrective actions as part of its assessment of whether it should engage or continue to engage the CPA firm.

Common Misconceptions of Peer Review

A peer review is an evaluation of work performed by the CPA firm and may have limitations.

1. *Fiction:* A peer review evaluates every engagement audited by a CPA firm.

Fact: A peer review is performed using a risk-based approach. In addition to other procedures performed, a peer reviewer selects a reasonable cross-section of the firm's engagements so that the reviewer has a reasonable basis to determine whether the reviewed firm's system of quality is designed in accordance with professional standards and if the reviewed firm is in compliance with it. Therefore, it is possible that the review would not disclose all weaknesses in the system of quality control or all instances of lack of compliance with it.

2. *Fiction:* A pass rating provides assurance with respect to every engagement conducted by the firm.

Fact: Every engagement conducted by a firm is not included in the scope of a peer review, nor is every aspect of each engagement reviewed. The peer review includes reviews of all key areas of engagements selected.

Questions for the CPA Firm Regarding Peer Review

The following questions may be helpful to the audit committee to gain a better understanding of the CPA firm and its peer review reports.

Question	Yes	No	Comments
1. Has the firm previously or currently been subject to peer review? If not, please explain.	<input type="checkbox"/>	<input type="checkbox"/>	

2. Were there any deficiencies or findings for further consideration noted as part of the peer review? Explain what the deficiencies or findings mean.	<input type="checkbox"/>	<input type="checkbox"/>	
3. Does the firm’s letter of response demonstrate that the firm is committed to making the changes necessary to improve its practice? If not, please explain.	<input type="checkbox"/>	<input type="checkbox"/>	
4. Was the peer review report a rating of pass with deficiencies or fail? Explain.	<input type="checkbox"/>	<input type="checkbox"/>	
5. Was our entity’s audit selected for review during the peer review? If so, were any matters from our audit noted? Explain.	<input type="checkbox"/>	<input type="checkbox"/>	
6. Did our audit’s engagement partner (and/or other key engagement team members) have other audit engagements selected for review during the peer review? If so, were any matters noted?	<input type="checkbox"/>	<input type="checkbox"/>	

Public Company Accounting Oversight Board Inspection

The Sarbanes-Oxley Act of 2002 (the Act) established the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of issuers as defined in the Act. The Act also amended the Securities Exchange Act of 1934 to rest responsibility for the appointment, compensation, and oversight of any listed public company’s auditor with a committee of independent directors. PCAOB established an inspection program to assess the degree of compliance of each registered public accounting firm and firm personnel with the Act. PCAOB also issued Release No. 2012-003, *Information for Audit Committees about the PCAOB Inspection Process*, in August 2012, to assist audit committees understand the inspections and gather information about the CPA firms.

All firms auditing public company clients are required to register with the PCAOB. Registered public accounting firms auditing more than 100 issuers are subject to annual inspection by the PCAOB. All other registered firms are subject to an inspection every three years. The PCAOB inspection focuses on a firm’s SEC practice only.

The PCAOB inspection focuses on the firm’s audit practice with respect to SEC registrant organizations. Following the inspection, the PCAOB will issue a report in two parts: (1) a public report that includes a description of the inspection procedures and description of issues identified

in the course of reviewing selected audit engagements without identification of the specific client engagements; and (2) a non-public report addressing criticisms of or potential defects in the firm's system of quality control. The non-public report could be made public if the criticisms or defects are not addressed by the firm to the satisfaction of the PCAOB within 12 months of the date of the inspection report.

Questions for the Audit Committee Regarding the PCAOB Inspection

While the PCAOB inspection does not include a CPA firm's other clients such as private company practices, it can still provide useful information to the audit committee of a government entity. If the firm performs public company audits in addition to government or not-for-profit entity audits, a PCAOB inspection report will be available. This report can provide insight about the firm in general and the following questions are ones that the audit committee should consider asking its auditors.

Question	Yes	No	Comments
1. Did the PCAOB identify deficiencies in audits that involved auditing or accounting issues similar to issues presented in our entity's audit?	<input type="checkbox"/>	<input type="checkbox"/>	
2. Has the firm taken actions necessary to correct the deficiencies noted? What was the audit firm's response to the PCAOB findings?	<input type="checkbox"/>	<input type="checkbox"/>	
3. Was the engagement partner (and other key engagement team members) selected for the PCAOB inspection? If so, were any negative comments noted on audits managed by them?	<input type="checkbox"/>	<input type="checkbox"/>	
4. Is the firm addressing (or has it addressed) the matters that were included in the non-public report from the PCAOB? Does the firm anticipate that the matters will be resolved, or is there a risk that the non-public report will become public after 12 months?	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is there anything else of note related to the PCAOB inspection that we should be aware of?	<input type="checkbox"/>	<input type="checkbox"/>	

Chapter 6: Guidelines for Hiring the Chief Audit Executive (CAE)

Overview: The internal audit function is a key component in providing assurance to the effectiveness of an entity's internal control structure. As a result, careful efforts must be taken in hiring the right chief audit executive (CAE), one who fits the entity's needs with the necessary technical expertise, but also one who meets other requirements, such as industry experience, temperament, integrity, management and human relationship skills.

Background: An internal audit function aids government entity audit committees in carrying out their oversight and fiduciary responsibilities through its focus on governance, risk management, and internal control. Appointing a CAE is thus a critical undertaking for any organization. The Institute of Internal Auditors (IIA), the standard setting organization for internal auditors, provides guidance on the appointment of the CAE.

Role of the Audit Committee in Hiring and Evaluating the CAE

In most entities, the CAE will report functionally to the audit committee and administratively to a senior executive of the entity such as the CEO.

A critical activity of the audit committee is to be involved in the hiring of the CAE of the entity. Given the CAE's high degree of interaction with senior management and the audit committee, it is imperative that the CAE demonstrates the attributes and skills appropriate for such interactions.

CAE Qualifications

Candidates for a CAE position should have strong management and leadership skills and have distinguished themselves professionally by earning either a CPA or a Certified Internal Auditor (CIA) credential.¹ A strong knowledge of internal audit, technical skills and experience is also an advantage. When evaluating the qualifications of candidates for a CAE position, the following competencies should be considered:

- Certified public accountant with active status
- Experience conducting independent audits in accordance with professional standards
- Experience preparing report for senior management recommending corrective action

¹ It is strongly encouraged that all CAEs, either before appointment or within a reasonable time period after appointment, demonstrate a strong understanding of the roles and responsibilities of internal audit, the Institute of Internal Auditor's International Professional Practices Framework, and audit technical skills through attainment of the Certified Internal Auditor® (CIA®) designation.

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- Experience communicating results of audits and investigations to boards or audit committees (or both)
- Knowledge and ability to remain abreast of current industry and professional auditing standards
- Ability to accurately assess and evaluate situations
- Good judgment and strength of character
- Uncompromising ethics and integrity
- Intellectual curiosity
- A focus on quality and professionalism
- Business acumen
- Excellent verbal and written communication skills
- Open and unbiased strong listening skills
- Persuasion and collaboration skills that balance diplomacy with assertiveness
- Critical thinking skills
- Excellent facilitation, problem-solving, and consensus building skills
- Excellent people management skills

Instructions for this tool: The audit committee should consider asking the following questions of candidates who have passed the initial employment screening by either the entity’s human resources department or an outside recruiting firm. Note that some sample questions may not be appropriate for your organization or the candidate.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
1. What do you consider to be internal audit’s role within the entity’s mission?	
2. What do you see as the biggest challenges for an internal audit team in the short term (3 to 6 months), medium term (6 to 12 months), and over the next 2 to 3 years?	
3. Have you used technology in conducting internal audits, and how has it enhanced conducting the internal audit? Describe your experience with data analytics.	
4. What experience do you have in this industry, and how do you plan to keep abreast of the significant developments relevant to internal audit in this industry?	
5. Have you worked with audit committees in the past? What processes have you put in place to keep the audit committee fully and appropriately informed? In the course of a year, what is the typical number of meetings/communications between the CAE and the audit committee (chair)?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
<p>6. Give some examples of situations you have faced that required special meetings with the audit committee (or open meetings as restricted to purpose within jurisdictions) as a result of disagreements with management. How were these situations resolved with management? Have there been situations in which management has tried to squash your recommendations or discredit your findings, and what was your response? In retrospect, would you now handle these situations differently?</p>	
<p>7. Have you worked with an Internal Control Framework (e.g., COSO or Green Book)? How has it influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?</p>	
<p>8. In your previous organization, what type of technology platform was used? Have you been involved in an enterprise resource planning (ERP) system implementation? What role did you play in the process and how did you make sure that the proper controls were in place when the system went live?</p>	
<p>9. Do you use a formal project planning process that is applied consistently for all internal audits? If so, what benefits have you derived in meeting your team’s goals and objectives? What is your average report cycle time from the end of fieldwork?</p>	
<p>10. What is the process that you use to develop the priorities of the internal audit function?</p>	
<p>11. What roles do the entity’s strategic and technology plans play in the development of an audit plan?</p>	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
12. What input do you seek to develop your audit objectives and scopes? How is this achieved? How have you resolved differences of opinion in this area without compromising the goals you have established for an audit?	
13. When you or your team conducts an internal audit, do you have a service orientation to your audit process? Do you work to improve the effectiveness and efficiency of the operations and controls in each audit area? How would you make your recommendations to management? What process would you use to resolve differences of opinion?	
14. Would you use a process for conducting a “customer satisfaction” survey after an internal audit is completed? How would you integrate this feedback into future audits?	
15. How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of the organization?	
16. How many people have you managed, either as direct reports, or within an organization that you might have overseen? How would you describe your management style? Have you ever participated in a 360-degree assessment process? If so, what did you learn about yourself that surprised you? How did the results of the assessment change your behavior?	
17. Describe a situation in which you were able to use persuasion to convince someone to see things your way?	
18. Describe a situation where you came up with an innovative solution to a challenge your organization was facing?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
Other Notes and Questions:	

Chapter 7: Engaging Independent Counsel and Other Advisers

Overview: An audit committee may need the expertise from outsiders other than the independent auditor. The tool in this chapter addresses considerations to assist audit committee members in understanding the process of engaging independent counsel and other advisers if needed.

When selecting independent counsel or other advisers (expert or adviser) for an engagement within the government entity, the audit committee should not only consider the education, training, and experience of the specialists and staff assistants actually performing the work, but it should determine that the service provider: (1) maintains integrity and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the government entity; (3) has the expertise and resources necessary to do the work it is under consideration to do; and (4) has a reputation for reliability, among other considerations. Inherent in the selection process is the audit committee's ethical responsibilities to avoid situations involving the appearance or actual conflict of interest or loss of objectivity (for example, the audit committee should avoid the appearance of "opinion shopping" or obtaining a predetermined outcome).

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources, while not all-inclusive, include the following:¹

1. Determine that the expert or adviser has the competence and experience to perform the requested service. Check references with other clients of the service provider.
2. Determine whether the expert or adviser has a conflict of interest with respect to the government entity. Such a conflict might arise if the expert or adviser has a relationship with the external auditor, or the subject of the engagement, or if he or she provides service to a competitor. Depending on the nature of the service to be offered, a conflict could arise if the expert or adviser has a relationship with a member of the governing body, or a member of the entity's management. Be aware of other potential conflicts of interest that may distract, or undermine, the work to be done.
3. Determine if the expert or adviser has sufficient resources to perform the work in the time frame specified by the audit committee.
4. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.
5. Obtain expert or adviser consent to issue a written report of the results of the effort and, during the engagement retention process, obtain a sample or intended format of

¹ In a government environment, these considerations are typically part of the formal procurement process.

the report contents. This is particularly helpful if an audit adviser is hired by the audit committee and the audit adviser reviews the work of the incumbent auditor to address an issue. In this situation, the audit adviser is usually requested to sign a document that prevents the adviser from reporting issues discovered regarding the independent auditor's position or documentation of the issue.

6. Make sure all parties, including management and the expert or adviser, understand that the audit committee is the owner of the service relationship. Make sure that management understands that the expert or adviser is working on behalf of the audit committee and the audit committee expects management to be fully cooperative and forthcoming with respect to any information that may be requested.
7. Determine the criteria that will be used to measure the expert's or adviser's work and document those criteria in an agreement with the service provider.
8. Execute an engagement letter specifying the scope of services to be performed and the terms of the engagement.
9. Ensure that the external counsel or adviser clearly understands the reporting relationship(s) and to whom he or she will report and share the findings of the engagement.

As with any relationship, communication and expectations management are important and should be clearly established prior to the start of an engagement.

Part II: Key Responsibilities

Chapter 8: Internal Control: Guidelines and Tool for the Audit Committee

Overview: This chapter is intended to give the audit committee basic information about internal control systems, including their purpose and limitations, how to most effectively use them in the entity, and the requirements of management with respect to controls over financial reporting. Note that the primary responsibility of the audit committee with respect to internal controls is the system of internal controls over financial reporting and over compliance with laws, regulations, contracts, grant agreements, and abuse, and, if applicable, operations.

Internal Control Primer

In 1992, the Committee of Sponsoring Organizations (COSO)¹ of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, published a document called *Internal Control—Integrated Framework* (framework).² The COSO framework was cited as an example of a “suitable control framework” by the SEC, along with similar frameworks issued by Canadian and UK-based organizations, and has become widely used by U.S. companies, both public and private, and not-for-profit entities. The *COSO Framework* was updated and re-published in 2013 to reflect consideration of the dramatic changes in business and operating environments since its original release. Senior executives adopted internal controls to help them effectively manage the entities they run to achieve profitability goals and missions. The framework now provides an updated and comprehensive principles-based approach to understanding internal control.

The COSO framework defines internal control as “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.” The nature, extent, and formality of an entity’s system of internal control will vary because the entities are different in terms of organizational size; products and services offered (public, private, or not-for-profit); customer base; and regulatory requirements. Therefore, the internal control process should be tailored to fit that entity’s operating environment. The process consists of ongoing tasks and activities effected by people that are able to provide reasonable but not absolute assurance of operating effectiveness. As such, the system of internal controls may range from highly formal and structured to informal and less structured and may still be effective.

¹ The Committee of Sponsoring Organizations consists of the American Institute of CPAs (AICPA), the Institute of Management Accountants (IMA), the Institute of Internal Auditors (IIA), Financial Executives International (FEI), and the American Accounting Association (AAA).

² The COSO publication *Internal Control—Integrated Framework* (Product Code Numbers 990025P and 990025E), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the *Framework* are used to support the continuing work of COSO.

Standards for Internal Control in the Federal Government (known as the Green Book),³ provides an overall framework for establishing and maintaining an effective system of internal control. The term “internal control” in the Green Book covers all aspects of an entity’s objectives (operations, reporting, and compliance). The Green Book may be adopted by state, local, and quasi-governmental entities, as a framework for a system of internal control. Management of a government entity determines, based on applicable laws and regulations, how to appropriately adapt the standards presented in the Green Book as a framework for the government entity.

The COSO framework sets forth three categories of objectives:

1. Operations objectives refer to the effectiveness and efficiency of the entity’s operations, which includes operational and financial performance goals and safeguarding of resources.
2. Reporting objectives pertain to the reliability of financial reporting and its preparation and includes published financial statements and their related derived data such as earnings releases.
3. Compliance objectives involve the adherence to laws and regulations to which the entity is subject.

The COSO framework introduced the five components of internal control. The Green Book adapts these components for a government environment. According to COSO and the Green Book, internal control consists of five interrelated components as follows:

1. *Control environment.* The control environment is the foundation of the system of internal controls and sets the tone for the organization. It provides the discipline, structure, and expectations for carrying out internal control across the organization. The governing body and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct and how directions are provided and responsibilities and authorities are assigned. The control environment also comprises the employees’ integrity, ethical values, knowledge, and management’s philosophy and operating style, including how employees are developed.
2. *Risk assessment.* Risk assessment involves an ongoing process for identifying, analyzing, and managing risks to help the entity achieve its objectives. Management should be cognizant of the ever-changing conditions in the entity’s internal and external environments, including economic, regulatory, and operating conditions, and adopt mechanisms to effectively manage business risks.
3. *Control activities.* Control activities are the actions established by policies and procedures to help ensure that management directives are carried out. Control activities are the actions to mitigate risks and are performed at all levels of the entity and at various stages within business processes. Control activities can prevent or detect errors and may be manual or automated. These activities include, but are not

³ This document (GAO-14-704G, September 2014) is available through GAO’s website (<http://www.gao.gov>).

limited to, approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

4. *Information and communication.* Information is necessary for people to carry out their responsibilities so an entity can achieve its objectives. It must be identified, captured, and communicated to people in the right format and at the right time. Communications occur both externally and internally. Within an organization, information must be communicated in all directions to allow employees to carry out day-to-day activities. Communication enables employees to understand internal control responsibilities and their importance to the achievement of objectives.
5. *Monitoring Activities.* Monitoring activities consist of ongoing assessments, separate evaluations, or a combination to assess the quality of the system of internal control. They are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning. The ongoing assessments are the activities of managers and supervisors to continually evaluate control requirements. On the other hand, separate evaluations are used periodically to determine whether controls are established and functioning as intended. While assessments are done at different times, deficiencies should be identified and communicated to staff and management in a timely manner, with serious matters reported to senior management and to the governing body.

The five components of the system of internal control are intertwined with the organization's operating activities, and are most effective when controls are built into the organization's infrastructure, becoming part of the very essence of the organization.

Internal Control Effectiveness

An effective system of internal controls provides an entity with reasonable assurance of achieving its objectives. An effective system of internal controls reduces, to an acceptable level, the risk of not achieving an entity's objectives. Effective internal control requires that each of the five components is present and functioning; it also requires that the components operate together in an integrated manner. Internal control can be judged as effective if the governing body and management have reasonable assurance of achieving an entity's operations, reporting, and compliance objectives, as follows:

1. The organization
 - achieves effective and efficient operations when external events are considered unlikely to have a significant impact on the achievement of objectives or when the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level; and
 - understands the extent to which operations are managed effectively and efficiently when external events may have a significant impact on the achievement of objectives, and the impact cannot be mitigated to an acceptable level.

2. The organization prepares reports in conformity with applicable laws, rules, regulations, and standards established by legislators, regulators, and standard setters, or with the entity's specified objectives and related policies.
3. The organization complies with applicable laws, rules, and regulations.

Internal Control Limitations

Even though a system of internal control is important to an organization in achieving its objectives, an effective system of internal controls is not a guarantee that the organization will be successful. An effective internal control structure will keep the right people informed about the organization's progress in achieving its objectives, but it cannot turn a poor manager into a good one. Internal control cannot ensure success, or even survival.

Internal control is not an absolute assurance to management and the governing body that the organization has achieved its objectives. It can only provide reasonable assurance, due to limitations inherent in a system of internal controls. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as faulty judgments that could be made at any level of management.

In addition, controls can be circumvented by collusion or by management override. Otherwise, effective internal controls cannot be relied upon to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management. The audit committee must evaluate whether there are oversight mechanisms in place and functioning that will prevent, deter, or detect management override of internal controls.

Roles and Responsibilities

Everyone in the organization plays an important role in the system of internal controls.

GOVERNING BODY AND AUDIT COMMITTEE

Members of the Governing Body. The governing body is responsible for overseeing the system of internal controls, and plays a key role in setting expectations about integrity and ethical values, transparency, and accountability for the performance of internal control responsibilities. Governing body members should be objective, capable and inquisitive, with a willingness to commit the time necessary to fulfill their governance responsibilities. To fulfill its responsibilities, the governing body should seek input about potential deficiencies in controls from external and internal auditors.

Audit Committee. The audit committee plays a critical oversight role in the reliability of the financial statements and the system of internal controls over financial reporting in addition to the processes in place to design, implement, and monitor the entity's broader system of internal controls. Audit committee members should understand how management is carrying out its internal and external reporting responsibilities and, when necessary, verify that timely corrective actions are taken.

SENIOR MANAGEMENT

Head of the Agency. The head of the agency has ultimate responsibility and ownership of the system of internal controls, with accountability to the governing body. The individual in this role sets the tone at the top that affects the integrity and ethics and other factors that create the positive control environment needed for the internal control system to thrive. The head of the agency maintains visibility and control over the risks the government entity faces, and reviews deficiencies that impact the system of internal controls. The day-to-day design and operation of the system of internal controls is delegated to key senior managers in the entity, under the leadership of the head of the agency.

CFO. Much of the internal control process flows through the accounting and finance area of the organization under the leadership of the CFO. In particular, controls over financial reporting fall within the domain of the chief financial officer. The audit committee should use interactions with the CFO as one of several important tools to obtain or increase their comfort level on the completeness, accuracy, validity, and maintenance of the system of internal control over financial reporting.

In a government entity, executives and senior management should, among other things, set the appropriate “tone at the top” for the entity’s control environment by doing the following:

- Ensuring that executives and management at all levels of the entity understand their role in cultivating the proper level of control awareness and play an integral part in establishing and maintaining internal control
- Mandating accountability through properly established policies and procedures and monitoring compliance on an ongoing basis
- Designing internal control so that risks are effectively managed and that material weaknesses are identified and reported to the appropriate level of management in a timely manner
- Requiring disclosure to the entity’s auditors and the audit committee of (a) all significant deficiencies in the design or operation of internal controls that could adversely affect the entity’s ability to record, process, summarize, and report financial data, as well as any material weaknesses in internal control; and (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the entity’s internal control

DAY-TO-DAY INTERNAL CONTROLS FUNCTIONS

Controller. The controller has many of the key control activities for financial reporting. It is important for the controller to understand the need for a system of internal control, to be committed to carrying out the requirements, and to communicate its importance within the organization. Further, the controller must demonstrate the commitment for the controls through his or her actions. This function monitors trends, provides guidance, and keeps the organization informed of relevant requirements. It is important that this functions coordinates and share issues among his or her peers to help the organization achieve its objectives.

Internal Audit. Internal audit is responsible for evaluating the effectiveness of the system of internal control and contributing to its ongoing effectiveness. Because internal audit generally reports directly to the audit committee and the most senior levels of management, it often plays a significant role in monitoring the effectiveness of a system of internal control in the government entity.

External Audit. The external auditor is engaged by the organization to audit the reliability of financial reporting and, in certain reporting jurisdictions, the effectiveness of internal control over financial reporting and compliance. In carrying out these responsibilities, the external auditor will communicate deficiencies in internal control to management to be acted upon and, depending on significance, to the audit committee. When hiring external auditors, the organization still retains full responsibility for the system of internal control, therefore, the audit committee should ensure that management (or an Office of Inspector General or equivalent, if applicable) has processes to evaluate the work performed by the external auditors as it relates to internal control.

Other Personnel. The system of internal control is only as effective as the employees throughout the organization who must comply with it. Employees should understand their roles in the system of internal controls, the importance of supporting controls through their own actions, and encouraging compliance by colleagues throughout the organization.

Internal Control Over Financial Reporting

Internal controls exist throughout an organization and may cover the organization as whole or may cover individual functions or transactions. Frequently used terms when discussing internal controls include:

Entity-level controls. Entity-level controls permeate all levels of the organization, and they establish the “tone at the top.” Examples include the following:

- Controls related to the control environment
- Controls over management override
- The risk assessment process
- Centralized processing and controls, including shared service environments
- Controls to monitor results of operations
- Controls to monitor other areas, including activities of the internal audit function, the audit committee, and self-assessment programs
- Controls over the period-end financial reporting process
- Policies that address significant business control and risk management practices

Compensating controls. Compensating controls address potential concerns about limited segregation of duties. These controls include managers reviewing system reports of detailed transactions; selecting transactions for review of supporting documents; overseeing periodic

physical counts of inventory, equipment, or other assets and comparing them with accounting records; and reviewing reconciliations of account balances or performing them independently. The lack of segregation of duties is not automatically a material weakness, or even a significant deficiency, depending on the compensating controls that are in place.

Deficiency. The design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Example: A member of the accounting department has been assigned responsibility to perform reconciliations on all bank accounts on a monthly basis. This person also has responsibility for opening the mail and preparing the daily deposit to the bank. The person's manager is required to review each completed reconciliation, but the manager does not sign off consistently on the reconciliation indicating review. In this scenario, two internal control deficiencies exist: (1) the lack of segregation of duties because one individual is preparing the cash deposit and reconciling the cash accounts, and (2) the lack of documentation of a control because the manager did not sign-off the reconciliation indicating a completed review.

Significant Deficiency. A deficiency, or a combination of deficiencies, in internal controls over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the entity's financial reporting. Alone or with other deficiencies, a significant deficiency results in more than a remote likelihood that a misstatement of the financials that is more than inconsequential in amount will not be prevented or detected.

Example: The organization is funded by a variety of grant agreements and contracts, making it necessary for the accounting department to review each grant agreement and contract to ensure proper revenue recognition. Because each grant agreement and contract is not always reviewed, revenue has been misstated on occasion. It is unlikely that any single grant agreement or contract could result in a material misstatement of revenue, and there are controls in place to ensure that material misstatements do not occur. However, a misstatement that is more than inconsequential yet less than material could result, creating a significant deficiency in internal control.

Material Weakness. A deficiency, or a combination of deficiencies, in internal controls over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

Examples of weaknesses that likely would be considered material depending on the circumstances include the following:

- Ineffective oversight by the audit committee over the external financial reporting process, and internal controls over financial reporting
- Material misstatements in the financial statements not identified initially by internal controls
- Significant deficiencies that have been communicated to management and the audit committee but that remain uncorrected after a reasonable period of time

- Restatement of previously issued financial statements to correct a material misstatement
- For larger, more complex entities, ineffective internal audit functions
- For complex entities in highly regulated industries (for example, healthcare), an ineffective regulatory compliance function
- Fraud of any magnitude on the part of senior management
- An ineffective control environment

The severity of a deficiency depends on two factors: (1) whether there is a reasonable possibility that the entity's controls will fail to prevent or detect a misstatement of an account balance or disclosure, and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies. It is important to note that the severity of a deficiency does not depend on whether a misstatement actually occurred but rather on a reasonable possibility that the entity's controls will fail to prevent or detect a misstatement. In determining whether a deficiency rises to the level of resulting in a misstatement of an account balance, risk factors need to be considered. These risk factors include, but are not limited to the following:

- The nature of the financial statement accounts, disclosures, and assertions involved
- The susceptibility of the related assets or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant
- The interaction of the deficiencies
- The possible future consequences of the deficiency (for example, reduced grant or government funding)

For additional guidance, refer to AU-C section 265, "Communicating Internal Control Related Matters Identified in an Audit" (AICPA, *Professional Standards*).⁴

The audit committee needs to be advised and updated regularly on the external auditor's consideration of internal controls as part of the financial statement audit, and should have a clear understanding of the expected outcome. If the auditor identifies internal control deficiencies, management should have a plan in place to correct weaknesses, and the audit committee should already be engaged in the review and approval of that plan.

Conclusion

⁴ See also AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, PCAOB AS No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* and International Standards on Auditing 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*.

The AICPA Audit Committee Toolkit: Government Entities

This chapter is intended to provide an overview of the basic information about internal control including its purpose and limitations, key terms, and responsibilities of the audit committee, especially as they relate to internal control over financial reporting. The concepts are not complex, but sometimes the application of the controls can be a challenge in a government entity, depending on its size and the culture. The audit committee plays an important role in establishing an appropriate control environment or the “tone at the top” of the government entity.

While the objective of reliable financial reporting may be paramount for the audit committee of a not-for-profit entity, an effective system of internal controls also encompasses compliance, operational, and non-financial reporting objectives. Establishing an integrated process that includes all five components of the internal control framework and is the primary means of having reasonable assurance that these three important objectives are being met. Simply stated, a strong system of internal control, both in its design and operation, is good business.

Internal Control—Checklist of COSO Essentials for the Governing Body

Purpose of this tool: This checklist provides an understanding of key governing body-level responsibilities within each of the five interrelated components of an entity's system of internal controls, as described in the *COSO Internal Control—Integrated Framework (2013)* and the Green Book. Refer to the “Internal Control Primer” section of this chapter for a discussion of the COSO components. The audit committee's role within the framework focuses on internal controls over financial reporting and the processes in place to design, implement, and monitor the entity's broader system of internal controls. It is also responsible to aid the governing body in its oversight of internal controls, risk management and overall governance process. This can be achieved through the committee's interaction with senior management, independent auditors, external and internal auditors, and other key members of the financial management team.

Instructions for using this tool: Within each component is a series of questions that the audit committee should evaluate to assure itself that board-level controls are in place and functioning. These questions should be discussed in an open forum with the individuals who have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, which should include key members of the financial management team, internal auditors, and external auditors. **This governing body-level tool should be used in conjunction with the *COSO Internal Control—Integrated Framework (2013)* and the Green Book to determine if all components and related principles of an entity's internal control system are present, functioning, and operating together in an integrated manner.** Evaluation of the internal control structure is not a one-time event, but rather a continuous process for the audit committee. The audit committee should always have its eyes and ears open to the ever-changing risks that the business faces, especially the risks to reliable financial reporting, and should continually probe the responsible parties regarding the operation of the system and potential weaknesses in internal control. These questions are written in such a manner that a “No” response indicates a weakness that should be addressed.

COSO Framework	Yes	No	Not sure	Comments
Control Environment—Demonstrates Commitment to Integrity and Ethical Values				
1. Do comprehensive standards of conduct exist to address acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior for the entity? Is the governing body accountable for the definition and application of the standards?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are the standards of conduct regularly communicated and reinforced to all levels of the entity, outsourced service providers, and business partners? Are management’s efforts to communicate the standards both sufficient and effective in creating awareness and motivating compliance? See also chapter 9, “Fraud and the Responsibilities of the Audit Committee,” in this toolkit.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Do the governing body and management demonstrate through actions and behaviors their commitment to the standards of conduct? Is there consistency at all levels of the entity? Is appropriate action taken in response to violations to the standards of conduct?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Environment—Exercises Oversight Responsibility				
4. Does the governing body define, maintain, and periodically evaluate the skills and expertise needed among its members to enable them to ask probing questions of senior management and take commensurate actions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
5. Does the governing body set the expectations for the performance, integrity, and ethical values of senior management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does the governing body assume oversight responsibility for management's design, implementation, and conduct of internal control?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Environment—Establishes Structure, Authority, and Responsibility				
7. Has the governing body established appropriate oversight structures and processes (i.e. board and committees) for the entity? Is the organizational structure within the accounting function appropriate for the size of the entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Does the governing body retain authority over significant decisions and review management's assignments and limitations of authorities and responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Environment—Demonstrates Commitment to Competence				
9. Do governing body committees contain members who have the requisite level of skills and expertise commensurate with the committee's responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
10. Are governing body oversight effectiveness reviews commissioned periodically, with opportunities for improvement identified and addressed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
11. Is the governing body effective in exercising its fiduciary responsibilities to external stakeholders (as applicable) and due care in oversight (for example, prepare for and attend meetings, review the entity’s financial statements and other disclosures)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Does the governing body or its committee evaluate the performance, integrity and ethical values of senior management and address shortcomings? Is the governing body informed about turnover of key personnel?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Do succession plans, contingency plans, or both exist for the CEO and other key personnel to assign key responsibilities in internal controls?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Environment—Enforces Accountability				
14. Does the governing body challenge senior management by asking probing questions about the entity’s plans and performance, and require follow-up and corrective actions, as necessary?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15. Does the governing body act to address competence, internal control, and standards of conduct shortcomings among the head of the agency, the entity, and its outsourced service providers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
16. Does the governing body or its committee align executive compensation, incentives, and rewards appropriately, including consideration of related pressures, with the fulfillment of internal control responsibilities in the achievement of objectives?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Risk Assessment				
1. Does the governing body consider significant risks to the achievement of objectives from external sources, such as creditor demands, economic and regulatory conditions, labor relations, and sustainability? Does the entity identify related issues and trends?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the entity consider significant risks to the achievement of objectives from internal sources, such as business continuity, retention of and succession planning for key employees, financing and the availability of funding for key programs, competitive compensation and benefits, and information systems security and disaster recovery? Does the entity identify related issues and trends?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Does management have a process in place to proactively assess risk of significant changes, such as entering a new market, disruptive innovations, economic/geo-political shifts, fraud, and management override of internal controls?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
4. Does the governing body apply an appropriate level of skepticism and challenge management’s assessment of risks? Is the risk of misstatement of the financial statements considered, and are steps taken to mitigate that risk?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Activities				
1. Does the governing body assume the responsibility to oversee senior management effectively in its performance of control activities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the governing body have necessary assurance from management, internal and external auditors, and others (as appropriate) that control activities are designed effectively and operating to address all significant risks to the preparation of reliable financial statements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Does the governing body make specific inquiries of management regarding the selection, development, and deployment of control activities in significant risk areas and remediation as necessary? Does the entity design control activities proactively to address emerging significant risk areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Information and Communication				
1. Do the governing body and management have an effective level of communication in place to enable fulfillment of their roles with respect to the entity’s objectives and to enable consistency in direction and tone at the top?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
2. Does the governing body receive the necessary operational and financial information relating to the entity's achievement of objectives on a timely basis and in a format that facilitates its use? Does the governing body review and discuss this information?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Does the governing body apply critical judgment effectively to scrutinize information provided and present alternative views?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does the governing body review disclosures to external stakeholders for completeness, relevance, and accuracy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Does the governing body receive communications regarding relevant information from third party assessments?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Do open communication channels exist to allow relevant information to flow to the board from internal and external sources including stakeholders, auditors, regulators, and employees?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Is there an effective process established and publicized periodically to political officials, employees, and others to allow open communication of suspected instances of wrongdoing by the entity or employees? See also the tool entitled "Whistleblower Common Practices Checklist" in chapter 10, "Whistleblower Policy: Complaint Reporting Procedures and Tracking Report," in this toolkit.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
Monitoring Activities				
1. Does the governing body understand the nature and scope of monitoring activities including ongoing assessment and/or separate evaluations to enable an effective determination of whether the components of internal control continue to function over time?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the governing body inquire of management, internal and external auditors, and others (as appropriate) to understand the presence and nature of any management overrides of controls?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Does the governing body receive regular communications from management regarding its evaluation of internal control and the status of remediation of deficiencies?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does the governing body engage with management, internal and external auditors, and others (as appropriate) to evaluate the adaptability of the entity's strategies and internal control framework to evolving business, infrastructure, regulations, and other factors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Chapter 9: Fraud and the Responsibilities of the Audit Committee: An Overview

Overview: An audit committee should take an active role in the prevention and deterrence of fraud, in addition to implementing and maintaining an effective ethics and compliance program. Effective audit committees challenge management constantly, and the auditors should take steps continually to ensure that the government entity has appropriate antifraud programs and controls in place. With those controls, management will be able to identify potential fraud and undertake investigations when instances of fraud are detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This chapter is intended to make audit committee members, including members of the governing body of the government entity, aware of their responsibilities as they undertake this important role. This chapter also highlights areas of corporate activity that may require additional scrutiny by the audit committee.

Since the recent financial scandals, and with the passage of the Sarbanes-Oxley Act of 2002, the public's expectations have been raised about all parties involved in organizational governance, including the audit committee, management, independent auditors, internal auditors, regulators, and law enforcement. The audit committee's role has been elevated greatly as a result of such fraud discoveries and by recent legislation.

Regulations such as the U.S. Foreign Corrupt Practices Act of 1977 (FCPA), the 1997 Organisation for Economic Co-operation and Development Anti-Bribery Convention, the U.S. Sarbanes-Oxley Act of 2002, the U.S. Federal Sentencing Guidelines of 2005, and similar legislation throughout the world have increased management's responsibility for fraud risk management.¹

Fraud can be costly to all types of organizations, including government entities. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated 5 percent of annual revenues to fraud.²

Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. According to *Black's Law Dictionary* (Tenth Edition, 2014, p. 775), *fraud*

...a knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment. A reckless misinterpretation made without justified belief in its truth to induce another person to act. Additional elements in a claim

¹ IIA, AICPA, ACFE. *Managing the Business Risk of Fraud: A Practical Guide*. 2008, p. 5.

² ACFE, *2014 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2014, p. 8.

for fraud may include reasonable reliance on the misrepresentation and damages resulting from this reliance. Unconscionable dealing; the unfair use of the power arising out of the parties' relative positions and resulting in an unconscionable bargain...

...consists of some deceitful practice or willful device, resorted to with intent to deprive another of his right, or in some manner to do him an injury. As distinguished from negligence, it is always positive, intentional.... Fraud, in the sense of a court of equity, properly includes all acts, omissions, and concealments which involve a breach of legal or equitable duty, trust, or confidence justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.³

The AICPA defines *fraud* as “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.”

Fraud affecting the organization generally falls within one of three categories:

1. *Financial statement fraud*, where an employee intentionally causes a misstatement or omission of material information in the organization's financial reports (for example, recording fictitious revenues, understating reported expenses or artificially inflating reported assets).
2. *Corruption*, where an employee misuses his or her influence in a business transaction in a way that violates his or her duty to the employer to gain a direct or an indirect benefit, such as schemes involving bribery or conflicts of interest.
3. *Asset misappropriation*, where an employee steals or misuses the organization's resources (for example, theft of organization cash, false billing schemes or inflated expense reports).

These fraud schemes can arise from the following sources within an entity:

1. *Executive fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of entity resources.
2. *Management fraud*, which involves middle management's intentional misrepresentation of financial statement transactions, for example, to improve their apparent performance.
3. *Employee fraud*, which involves non-senior employee theft or the improper use of entity resources.
4. *External fraud*, which involves theft or the improper use of resources by people who are neither management nor employees of the entity. Outside individuals may, for example, collude with management or employees.

³ Black's Law Dictionary: thelawdictionary.org/fraud/

Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud

The members of the audit committee should understand their role of ensuring that the government entity has a strong internal control environment in place, including the design and implementation of programs and controls to prevent and detect fraud. The audit committee also needs to be prepared to aid in the discovery of fraud, investigate, and report on its findings to the governing body or head of the government entity. The components of a robust fraud control program should include (1) a fraud risk assessment,⁴ (2) fraud reporting mechanisms and protocols, (3) investigation protocols, (4) a disciplinary action policy applied consistently, and (5) a process to identify and report conflicts of interest, usually in the form of an annual conflict of interest questionnaire completed by all employees.

The audit committee should ensure that the government entity has implemented an effective ethics and compliance program, and that it is tested periodically. The design of the internal control system should consider the risk of fraud explicitly. Since the occurrence of significant frauds can be attributed frequently to an override of internal controls, the audit committee plays an important role by validating the accuracy of information received by applying skepticism and ensuring that internal control both addresses appropriate risk areas and is functioning as designed.

Internal auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff who are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored, (2) organizational processes are effectively controlled and tested periodically, and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal auditors are carrying out their responsibilities in connection with potential fraud.

According to the ACFE, the most effective method for detecting fraud historically has been tips.⁵ In many cases, these tips are obtained through the use of whistleblower policies and hotlines. Government entities should use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act as a best practice. Sarbanes-Oxley section 301 requires audit committees of listed companies to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.⁶ For federal agencies, the Whistleblower Protection Act and the Whistleblower Protection Enhancement Act of 2012 provide specific requirements for whistleblower protection. Other government entities may have laws or regulations that establish specific requirements applicable in that specific government entity.

In many organizations, the audit committee is significantly involved in the primary investigation and review of the whistleblower complaints and reporting. In addition, some organizations have

⁴ The COSO publication *Internal Control—Integrated Framework*, Principle 8, (p. 78) describes the assessment of fraud risk as one of the fundamental concepts of internal control within an organization.

⁵ ACFE. *2014 Report to the Nation on Occupational Fraud and Abuse*. Austin, TX: ACFE, 2014, p. 19.

⁶ See also IIA, AICPA, ACFE. *Managing the Business Risk of Fraud: A Practical Guide*. 2008, p. 11, for guidance regarding the roles of management and staff.

designated the audit committee chair or an audit committee member as the individual who initially receives whistleblower reports. See also the tool in chapter 10, “Whistleblower Policy: Complaint Reporting Procedures and Tracking Report,” in this toolkit.

Governance Considerations

To set the appropriate tone at the top, elected government officials should first ensure that the elected officials themselves are governed properly. This encompasses all aspects of governance.

The elected government officials also have the responsibility to ensure that management designs effective fraud risk management documentation to encourage ethical behavior and to empower employees, customers, and vendors to insist those standards are met every day. In order to understand fraud risks relative to the entity’s mission and operations, the governing body should do the following:

1. Maintain oversight of the fraud risk assessment by ensuring that fraud risk has been considered as part of the entity’s risk assessment and strategic plans. This responsibility should be addressed under a periodic agenda item at board meetings when general risks to the entity are considered.
2. Monitor management’s reports on fraud risks, policies, and control activities, which include obtaining assurance that the controls are effective. The board should also establish mechanisms to ensure it is receiving accurate and timely information from management, employees, internal and external auditors, and other stakeholders regarding potential fraud occurrences.
3. Oversee the internal controls established by management.
4. Set the appropriate tone by actively promoting the ethical values of the entity by insisting that ethical behavior is an integrated part of all key executives’ job descriptions, hirings, evaluations, and succession-planning processes.
5. Have the ability to retain and pay outside experts where needed.
6. Provide external auditors with evidence regarding the governing body’s and the head of the government entity’s active involvement and concern about fraud risk management.
7. Monitor and assess reports of fraud in comparable organizations.

The governing body and the head of the government entity may choose to delegate oversight of some or all of such responsibilities to management or a committee established by the governing body. These responsibilities should be documented in the applicable job description or committee charters. The governing body should ensure it has sufficient resources of its own and approve sufficient resources in the budget and long-range plans to enable the entity to achieve its fraud risk management objectives through their delegees.

Expertise of Forensic Accounting Consultants

In some situations, it may be necessary for an organization to look beyond the independent audit team for expertise in the fraud area. In such cases, CPA and certified fraud examiner (CFE)

forensic accounting consultants can provide additional assurance or advanced expertise, since they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. Forensic accounting consultants, however, cannot act as insurers to prevent or detect fraud.

Many forensic accountants have obtained specific training in the identification and detection of fraud and may have additional designations such as certified fraud examiner. More information about certified fraud examiners may be located at the ACFE's website, www.acfe.com.

When Fraud Is Discovered

Fraud can be discovered through many sources, including internal or external auditors (including an Office of Inspector General (OIG) or similar entity), forensic accounting consultants, employees, and vendors. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of a government entity's overall ethics, compliance, and fraud prevention program. Although a confidential hotline (typically in an OIG or similar entity) is something that could be accomplished internally, a variety of outside service providers can be engaged to provide this service for the government entity.

If fraud or improprieties are asserted or discovered, the audit committee—through the independent external auditors, internal auditors, forensic accounting consultants, or others as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the government entity's behalf. See the tool in chapter 7, “Engaging Independent Counsel and Other Advisers,” in this toolkit. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation, and if it is desirable, for an independent assessment.

If fraud is discovered while working with an OIG or similar entity, or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. Criteria should be in place describing the audit committee's level of involvement, based on the severity of the offense. Audit committees will also want to obtain information about all violations of the law and the organization's policies.

Forensic accounting consultants frequently can also provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification; (2) creation of special investigations units (SIUs); (3) incident management committees; (4) disclosure risk controls; and (5) ethics hotlines and a code of conduct, if they are not already in place.

The audit committee can engage the incumbent audit firm to carry out a forensic/fraud investigation. It is important to recognize, however, that the audit firm would be precluded from serving subsequently as an expert witness in such circumstances. Audit committees should therefore consider the use of forensic professionals who are not affiliated with the audit firm, since they would not be subject to such constraints. If fraud is discovered and an investigation is necessary, the entity's general counsel or an outside law firm should be engaged to determine how best to proceed with the investigation. In addition, if CPA forensic accountants are engaged by the entity's general counsel, rather than the audit committee, they may attain attorney-client privilege status potentially, which is not otherwise available under normal circumstances.

Conclusion

Reactions to recent corporate and not-for-profit scandals have led the public and stakeholders to expect government entities to take a “no fraud tolerance” attitude. Good governance principles demand that a government entity’s governing body and oversight committees ensure overall high ethical behavior in the organization, regardless of its status as public, private, government, or not-for-profit; its relative size; or its industry. The governing body’s role is critically important because major frauds have historically been perpetrated by senior management in collusion with other employees. Vigilant handling of fraud cases within a government entity sends a clear message to the public, stakeholders, and regulators about the governing body and management’s attitude toward fraud risks and about the government entity’s fraud risk tolerance. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. Independent public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. CPA forensic accounting consultants and certified fraud examiners (CFEs) have emerged as vital recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so that they may carry out their fiduciary responsibilities more effectively in the fight against fraud.

Chapter 10: Whistleblower Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report*

Overview: Audit committees of many government entities ensure that an effective process is in place to report any complaints received by the entity, whether generated internally or externally, regarding violations or suspected violations of laws or organizational policies. Having a whistleblower policy in place is a compliance best practice. An effective whistleblower policy and process is part of strong organizational governance by providing a means to address unethical or illegal activities.

Federal agencies are covered by the Whistleblower Protection Act and the Whistleblower Protection Enhancement Act of 2012. For Federal agencies, these laws should be the foundation for creating a whistleblower program. State and local government entities may have similar laws or regulations that define their respective whistleblower programs.

Reasons for a Whistleblower Policy

A vigorous whistleblower policy and procedure is a government entity's key defense against management override. The audit committee can help create strong antifraud controls by encouraging the development of a culture in which employees view whistleblowing as a valuable contribution to a workplace of integrity and their success. Federal law prohibits retaliation against anyone "blowing the whistle" with respect to a violation of federal law or regulation. To be effective, the reporting mechanisms must demonstrate confidentiality so potential whistleblowers are assured that their concerns will be considered properly, and that they will not be subject to retribution. Successful whistleblowing and anti-retaliation procedures require strong leadership from the audit committee, the governing body, and management at all levels within the government entity.

The audit committee plays a vital part in assuring that employees are required to promptly report any known or suspected violations of policies and procedures, laws, rules, or regulations by which the entity is governed. The audit committee must also ensure that employees are confident in the investigation process and are protected from retaliation.

* Note: This tool is included for illustrative purposes only. It has not been considered or acted upon by any senior technical committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the author and publisher are not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the entity should seek out the services of a competent professional.

Whistleblower Complaint Reporting Common Practices Checklist

Purpose of this tool: This checklist may be used by the audit committee members when evaluating the design and operating effectiveness of the whistleblower complaint reporting process. These questions are written in a manner such that a “No” response indicates areas where additional thought or action is recommended for an effective program.

	Yes	No	Not sure	Comments
Policy Components				
1. Has the entity developed and effectively communicated a complaint reporting policy to employees and external service providers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the policy describe the following:	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
a. A statement of purpose and the nature of concerns within the policy’s scope? Does the policy support and clarify how it differs from the entity’s normal complaint procedures?				
b. The parties involved in the receipt, handling, and disposition of complaints, including the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
c. The duty of all employees to promptly report any known or suspected violations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
d. The multiple channels for reporting a concern? Are these various methodologies clearly communicated?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
e. The confidentiality safeguards that an individual who makes a report can expect?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Yes	No	Not sure	Comments
f. The steps to follow to make an anonymous report, as well as the related handling procedures?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
g. The definition of good faith, credible reporting? Does the policy address the handling of vague complaints received from an anonymous source?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
h. The steps used to receive, investigate, and track reported issues?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
i. The retention requirement for complaints?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
j. The statement that violations can be reported without fear of retaliation, the process to report retaliation, and the process the entity will use to investigate suspected retaliation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
k. Additional procedures if the violation is in regard to the leader of the entity (for example, the president, executive director, or head of the agency)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
l. Procedures that governing body members should follow to make a complaint?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is the policy widely publicized and periodically recommunicated so that all members of the governing body, employees, and volunteers who provide substantial services to the entity have awareness?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Yes	No	Not sure	Comments
Procedural Components				
1. Is more than one communication channel available to employees, such as telephone, Web, or email? Do channels have sufficient ease of use and provide for confidentiality and anonymity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are the communication channels through which an issue must flow effective in ensuring that issues reach the audit committee for consistent evaluation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is there a mechanism in place that assures automatic submission of any issue involving senior management, the board, or an audit committee member directly to the audit committee without filtering?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Are all employees aware of the primary persons to whom they should report a matter? In the event the primary persons are absent or included in the potential complaint activity, have alternative persons been delegated to resolve the complaint?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is there a process that allows an individual to receive information about the disposition of his or her report at an appropriate level?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Are issues documented, tracked, investigated, and resolved in a timely manner?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

	Yes	No	Not sure	Comments
7. Are all issues received through the whistleblower channels reported to the audit committee for discussion?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Is the documentation for all issues maintained per a retention policy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Are internal audits performed regularly on the whistleblower program to assure the design and operating effectiveness of the defined protocols?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
10. Are employees required to sign a form annually attesting to adherence to the whistleblower policy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. Are all reports disposed of prudently and are all those involved advised of final disposition?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Sample Procedures for Handling Complaints (Whistleblower Policy)

Purpose of this tool: This tool could be used by the audit committee and management to document policies, procedures, and confidentiality requirements that a person with a complaint should follow to report and for the entity to track complaints received to an appropriate resolution.

Statement of Purpose

The government entity strives to conduct all of its activities according to high ethical standards. Adherence to this goal is imperative. The audit committee of the government entity's governing body has adopted these procedures for handling complaints to assist the governing body in meeting its ethical and legal obligations.

Employee Complaints

Employees are required to report any known or suspected violation of the organization's policies and procedures, laws, rules, or regulations by which our government entity is governed. The government entity requires any employee to report any matter which he or she views as questionable. Generally, such concerns should be raised initially with a supervisor, the director of Human Resources or through the complaint hotline. However, if an employee is unsuccessful in resolving a concern through such channels or believes that the concern will not be adequately addressed through such channels, the employee should contact a member of the audit committee. The names, telephone numbers, and e-mail addresses of the current members of the audit committee are listed on our government entity's intranet.

Any employee who learns of or is asked to participate in potentially non-compliant activities must report the matter immediately to his or her supervisor or to the director of Human Resources. If the potential non-compliant activity involves the supervisor and/or the director of Human Resources, the information should be reported to the general counsel or the complaint hotline. Complaints involving the chief executive officer, chief operating officer, chief financial officer, or general counsel should be made directly to the audit committee or the complaint hotline. Governing body members should also report any non-compliant activity directly to the audit committee.

Employees may submit their complaints in writing to the director of Human Resources. Given the sensitivity of such matters, we request that you label the correspondence "*Confidential*." Employees may submit concerns on a confidential, anonymous basis. If an employee does not want to be identified with the submission, he or she should not include his or her name in the correspondence, but, instead, indicate prominently on the submission that it is a "*Confidential, Anonymous Employee Submission*."

Employees may report their complaints confidentially to the complaint hotline. The complaint hotline number is XXX-XXX-XXXX. The complaint hotline telephone number shall be visibly posted in a manner consistent with employee notifications in locations frequented by the organization's employees. Employees may make reports anonymously. No caller will be required to disclose his or her identity, and no attempt will be made to trace the source of the call

or the identity of the caller when the caller requests anonymity. If the call is anonymous, the caller should leave sufficient information that the complaint may be fully investigated.

If a caller has revealed his or her identity, confidentiality will be maintained to the extent practicable by law. Callers should be aware, however, that it may not be possible to preserve anonymity if they identify themselves, provide other information which identifies them, the investigation reveals their identity, or they inform people that they have called the complaint hotline. Callers should also be aware that under certain circumstances the organization is legally required to report certain types of crimes or potential crimes and infractions to external governmental agencies.

Governing Body Complaints

Any governing body member who has a concern regarding what he or she views as questionable should bring these concerns to the attention of the audit committee.

A governing body member serving on the audit committee should contact the audit committee chair immediately and raise any such concerns so they can be discussed no later than at the first audit committee meeting held after he or she becomes concerned. It may also be prudent to convene a special meeting of the audit committee to discuss these concerns.

Processing, Tracking, and Investigating Complaints

The person who receives a report of a suspected violation shall document the complaint noting name and position of person providing the information (if provided), date reported, and brief description of the issue. This information should then be forwarded to the director of Human Resources or the appropriate channels. If the potential complaint involves the director of Human Resources or if the director of Human Resources is unavailable, the information should be reported to the general counsel. Any complaints related to the chief executive officer, chief operating officer, chief financial officer, general counsel, or a board member should be reported without delay to the chair of the audit committee.

The person receiving the complaint will assign the complaint a tracking number, log the complaint into the complaint tracking report, and immediately begin an investigation. The investigator will appropriately document the complaint, the investigation, and the resolution. A written report summarizing all of the complaints reported, investigatory findings, and any corrective actions taken will be presented to the audit committee semi-annually.

Retention of Complaints

Each investigator will maintain the complaint log and maintain a file of materials related to complaints on behalf of the organization. These materials will be retained for a period of five years, or for a longer period if required by law.

Non-Retaliation/Non-Retribution

The government entity will not tolerate any form of retaliation against any employee (1) who submits a good faith complaint or (2) who assists in an investigation of challenged practices.

All employees of the government entity are strictly prohibited from engaging in any act or conduct of behavior which results in, or is intended to result in, retaliation or retribution against any employee for reporting his or her concerns relating to a possible violation.

If an employee believes in good faith that he or she has been retaliated against for initiating a report or complaint or for participating in any investigation related to such report or complaint, then the employee should report the retaliation to his or her supervisor, the director of Human Resources or the organization's complaint hotline as soon as possible. The report should provide a thorough account of the incident(s) and should include names, dates of specific events, the names of any witnesses, and the location or name of any document in support of the alleged retaliation.

A thorough investigation will be conducted. Adverse actions in retaliation for an employee's report or complaint may result in discipline, up to and including termination, of the person or persons performing such actions.

Distribution of Whistleblower Policy

A copy of this policy will be distributed annually to all board members, employees and volunteers who provide substantial services to the organization. In addition, the policy and complaint hotline telephone number shall be posted visibly in a manner consistent with employee notifications in locations frequented by employees. A description of the Whistleblower Policy and Procedures is contained on our website at [*Insert URL*].

Compliance With the Government Entity's Whistleblower Policy

All employees will be required to annually sign a form attesting to, among other things, adherence to the organization's Whistleblower Policy. A periodic audit will be conducted to ensure adherence to and effectiveness of this policy.

Chapter 11: Issues Report From Management

Overview: The sample report in this chapter is to be used by management when considering significant issues, estimates, and judgments that may have a material effect on the government entity's financial statements, among other concerns. Management should be encouraged to use this tool as a means to document any significant issues, judgments, and estimates for discussion with the audit committee. Each matter should be prepared as a separate issues report. Statements should be clear and concise. Some issues may carry over to subsequent meetings, in which case, any updated information should be included in bold.

In many cases, management will communicate with the audit committee regarding the government entity's accounting policies, practices and estimates; and the independent auditor participates in the discussion and confirms that management has adequately communicated the required matters.

Defining Significant Issues, Critical Accounting Estimates, Significant Unusual Transactions, and Judgments

As a first step to any discussion of this nature, it is important for the audit committee to define its threshold for significant issues, critical accounting estimates, significant unusual transactions, and judgments.¹ A significant issue, critical accounting estimate, significant unusual transaction, or judgment is one that

1. creates controversy among members of the management team, or between management and the internal or independent auditor, or where there is a lack of authoritative guidance or consensus in practice;
2. has or will have a material effect on the financial statements, such as a critical accounting estimate or significant unusual transaction;
3. is or will be a matter of public interest or exposure;
4. must be reported in an upcoming filing with an external body, and management is unclear or undecided on its presentation (this may include the annual report;² federal, state, or local filings; and any bond filings);
5. results from the application of a new accounting standard. Note that the application of a new accounting standard may or may not be considered a significant issue, estimate, or judgment for the government entity. However, for the record, the audit committee

¹ The audit committee's threshold is separate from management or the independent auditor's materiality threshold for uncorrected misstatements although these thresholds should be taken into account (for example, when reviewing the management representation and legal representation letters) when the audit committee defines its own.

² For state and local government entities, this is the Comprehensive Annual Financial Report or CAFR. For federal entities, this is an Agency Financial Report (AFR) or Performance and Accountability Report (PAR).

- may ask management to use this format as a means to brief the audit committee on the application of the new standard;
6. applies to the initial selection or changes to significant accounting policies or application of such policies in the current period;
 7. relates to the application of a standard in a way that is not consistent with general practice;
 8. relates to key controls over financial information that are being designed, redesigned, have failed, or otherwise are being addressed by the entity;
 9. is used for consultation with other accountants; or
 10. corrects or accepts uncorrected misstatements.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, critical accounting estimates, significant unusual transactions, and judgments. At each meeting, the audit committee should inquire about current or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management's response should be documented in the meeting minutes. Management's report to the audit committee concerning these matters should contain the following elements for a proper basis of discussion by the audit committee:

1. *Definition of Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* In this section of the issues report, management should define and summarize the issue as concisely and clearly as possible.
2. *Management's Position.* This section should address management's position on the issue. If there is disagreement among members of management, those disagreements should be identified as explicitly as possible, with brief explanations of why each member of the management team has taken his or her respective position.
3. *Relevant Literature.* Any professional literature or regulatory requirements addressing this issue should be cited. If no professional literature is available, it would be appropriate to define industry practice. If this is a developing area, and there is neither accepted industry practice nor other sources to support and refute these positions, this fact should be reported. If there was a choice on the accounting treatment, it should be disclosed here, along with a discussion of how the choices of treatment were compared and the basis on which the final choice was made.
4. *Risks.* Management should identify and evaluate various risks (opportunities and threats) associated with this proposal.
5. *Regulatory Disclosure* (if applicable). Management must inform the audit committee about how it intends to address this issue in required filings with regulatory bodies as required by law (for example, insurance commissions, banking authorities, or others).
6. *Auditor's Position.* Has management consulted with the independent auditor on this issue? Does he or she agree with management's position? Has he or she addressed the audit issues that might be associated with it? If so, use this section of the issues report

to discuss the independent auditor's position. If not, use this section to state explicitly that the auditor has not been consulted.

7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* Management should use this section of the issues report to highlight other related and relevant information that is not already included in the sections above.

Sample Issues Report From Management

1. *Define the Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* In the government entity's 2013 financial statements, a \$500,000 contribution from a donor was reported in temporarily restricted net assets. No amounts were shown as released from restrictions during 2013. During 2014, the client determined that it should have released \$200,000 from restrictions in 2013. Does a restatement for a change in classification of net assets require a restatement of the 2013 financial statements?
2. *Management's Position.* Management is willing to restate the 2013 financial statements if required by GAAP.
3. *Relevant Literature.* Governmental Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements (December 2010)*.
4. *Risks.* Users of the 2013 financial statements relied on financial statements that understated unrestricted net assets and overstated temporarily restricted net assets.
5. *Regulatory Disclosure.* This issue is generally not applicable.
6. *Auditor's Position.* According to GASB Statement No. 62, "A correction of an error in previously issued financial statements should be accounted for and reported as a prior-period adjustment and excluded from the change in net assets section of the flows statement for the current period." (Paragraph 60) "When comparative statements are presented, corresponding adjustments should be made of the amounts reported in the flows statement and the statement of net assets for all of the periods reported therein to reflect the retroactive application of the prior-period adjustments." (Paragraph 61) "When prior-period adjustments are recorded, the resulting effects on the change in net assets of prior periods should be disclosed in the notes to the financial statements in the period in which the adjustments are made. ... When financial statements for more than one period are presented, the disclosure should include the effects for each of the periods included in the statements." (Paragraph 62)
7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* The auditor determined the \$200,000 was a material amount and concluded a restatement and disclosure were appropriate for the correction.

Issues Report From Management

1. *Define the Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.*
2. *Management's Position.*
3. *Relevant Literature.*
4. *Risks.*
5. *Regulatory Disclosure.*
6. *Auditor's Position.*
7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.*

Chapter 12: Guidelines and Questions for Conducting an Audit Committee Executive Session

Overview: It is generally accepted practice that audit committees should hold executive sessions with senior management, the CFO or equivalent of the financial management team, the Chief Audit Executive (CAE) or equivalent of the internal audit team,¹ and the partner, inspector general, independent government auditor, or equivalent independent auditor. The “Additional Questions to Consider” tool at the end of this chapter is designed to provide guidance as to the amplitude of the questions that should be asked. It is intended to assist the audit committee in asking the right *first* questions, with the understanding that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question(s). The tool also contains possible follow-up questions audit committee members can ask key members of the financial management team in order to improve their understanding of the day-to-day operating environment as well as the management teams’ decision-making processes and interactions.

What Is an Executive Session?

An executive session is a best practice employed by audit committees for many reasons. Here, we are advocating that the executive session be used to meet with key members of the executive management and financial management teams on a one-on-one basis. Typically within most government entities, there is a focus on transparency. As such, it is important that the individual facilitating audit committee meeting consults legal counsel to understand applicable laws that govern these types of meetings (e.g. open meeting laws, freedom of information, etc.).

Executive sessions should occur at every audit committee meeting, though not everyone needs to be in an executive session at every meeting. For example, it is appropriate for the CAE and the independent auditor to have an executive session at every meeting, but the CFO might be in executive session with the audit committee only at the meeting before year-end results are released.

During an executive session meeting, minutes are usually not recorded, and when meeting with specific members of the financial management team, anyone who is not a member of the audit committee is excluded from the meeting. The purpose is to ask questions of various members of staff in a safe environment. Executive sessions should be routine at every audit committee meeting, rather than an exception. In an open session, the audit committee should avoid asking whether an individual has anything to discuss in an executive session; that question alone could place the individual in an awkward position with others in the government entity and may deter

¹ The audit function, including internal audit, may also be performed by an Office of Inspector General (OIG) or similar entity in accordance with the statute that created the audit organization.

the purpose of the executive sessions. Questions for an executive session are designed to promote “safety” within an executive session and are based on areas that the discussants may not feel free to answer honestly in an open environment. In addition, there may be other information that the audit committee wants to know.

Asking open-ended questions in this kind of environment could be a major source of information for the audit committee. This tool includes examples of the types and depth of questions the audit committee should ask. These are meant to be sample questions to help start a conversation and create dialogue between the individual and the audit committee. ***These sample questions are not intended to be all-inclusive.*** Audit committee members must have the expertise not only to understand the answers to the questions, but also to use these answers to develop appropriate follow-up questions. It will not be unusual to ask similar questions of key executives, the independent auditor, or the CAE, as a comparison of their respective responses is a good source of insight. Depending on the answers, follow-up action may also be necessary, and the audit committee must be prepared to take that action. The most important thing to do when conducting an executive session is to *listen to the answers that are given and follow up on anything that you do not understand!*

Audit committee members should also consider the history of the government entity, the industry in which it operates, the current economic and political climate, and other factors when asking questions during the open audit committee meeting and in an executive session. Finally, the audit committee should remind management that its members are accessible even outside the meeting, and that he or she should feel free to contact the audit committee members at other times if the need arises.

It is important to note that not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of dual roles, and adjust the questions accordingly. The audit committee should explore how a function or role is accomplished, and compose questions appropriately. Also, the audit committee should consider and take into account other roles in the government entity. It may be that other people within a government entity should be asked to meet with the audit committee in an executive session.

Additional Questions to Consider: Tool for Audit Committee Members

Purpose of this tool: As a part of fulfilling your responsibilities as an audit committee member, this tool is intended to help you consider the types of questions you should be asking management during audit committee meetings or executive sessions. Your audit committee should be made up of members who have the expertise to evaluate the answers and the insight to identify the appropriate follow-up question. Also, the performance evaluations section has additional evaluation questions concerning the performance of the internal audit function, independent auditor role, and audit committee.

Note: There are four categories of questions (Fraud/Ethics, Internal Environment, Independent Auditor, Financial Statements) and varied positions of whom you might ask the same question (Government Entity Head, CFO, CAE, general counsel, CIO, and independent auditor role).

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
1. Do you believe the financial statements present the government entity's financial position fairly?	Financial Statements	X	X	X		X		X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
2. Has the government entity solicited or received advice from or given advice to any outside party on how to structure any transaction to produce a desired financial statement effect? If so, please provide details.	Financial Statements	X	X	X	X	X		X	
3. Do you believe the disclosures are adequate and that the average user of the financial statements will understand them?	Financial Statements	X	X	X		X			
4. Are you satisfied that an appropriate audit was performed by the independent auditor?	Independent Auditor	X	X	X		X	X		
5. Are you aware of any situations in which the government entity's accounting practices were manipulated?	Fraud/ Ethics	X	X	X	X	X			

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
6. Are you aware of any current or past fraud occurrence or any kind of fraud in the government entity? Do you know of any situations in which fraud could occur?	Fraud/ Ethics	X	X	X	X	X	X	X	
7. Have you encountered any situations in which the government entity complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	Fraud/ Ethics	X	X	X	X	X	X	X	
8. Do you feel comfortable raising issues without fear of retribution?	Fraud/ Ethics	X	X	X	X	X	X	X	
9. Are you aware of any disagreements between the government entity's management team and the independent auditor?	Independent Auditor	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
10. Are you aware of any disagreements between the government entity’s management team and the internal auditors?	Internal Environment	X	X	X	X	X	X	X	
11. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	Fraud/ Ethics	X	X	X	X	X	X	X	
12. Are there any questions we have not asked that we should have asked? If so, what are those questions?	Misc.	X	X	X	X	X	X	X	
13. Overall, is management cooperating with the internal auditor? Does management have a positive attitude in responding to findings and	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
recommendations, or is it insecure and defensive of findings?									
14. Has management set an appropriate tone at the top with respect to the importance of compliance with the internal control system around financial reporting?	Internal Environment	X	X	X	X	X	X	X	
15. Discuss areas in which there is an accounting treatment that could be construed as aggressive.	Financial Statements	X	X	X		X		X	
16. Do you have the freedom to conduct audits as necessary throughout the government entity?	Internal Environment			X				X	
17. Were you restricted or denied access to requested information?	Internal Environment			X	X			X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions										
Question	Concept	Position							Comments	
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role		
18. Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are findings and recommendations given the level of discussion needed to satisfy any issues raised to your satisfaction?	Fraud/Ethics			X					X	
19. Are you aware of any disagreements between the government entity's management and the independent auditor?	Independent Auditor		X	X		X			X	
20. Are there any issues since our last meeting that you wish to discuss with the audit committee?	Misc.	X	X	X	X	X	X		X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
21. Do you believe the financial statements and related disclosures convey the government entity's financial situation adequately to the governing body and the public?	Financial Statements		X	X	X	X		X	
22. Now that you have the opportunity, is there anything you want to tell the audit committee? Is there anything else that we need to know?	General.	X	X	X	X	X	X	X	
23. Are you satisfied with the presentation of information about the government entity in its financial statements?	Financial Statements	X	X	X	X			X	
24. Are you aware of any issues that could cause embarrassment to the government entity?	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
25. Is there any activity in the government entity with which you are uncomfortable, consider unusual, or that you believe warrants further investigation?	Internal Environment	X	X	X	X	X	X	X	
26. For independent auditors from CPA firms, explain the process the independent auditor uses to assure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to non-audit services, how do those services affect the work that you do or the manner in which the engagement team or others are compensated? Are you aware of any anticipated event that could possibly impair the independence, in fact or in appearance, of the independent audit organization or any member of the engagement team? Note: this question is not	Independent Auditor							X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
applicable to offices of inspector general or other government auditors.									
27. Have management, legal counsel, or others made you aware of anything that could be considered a violation of laws, regulations, GAAP, professional practice, or the ethics of business?	Independent Auditor	X	X	X	X			X	
28. Are there any areas of the financial statements, including the notes, which you believe could be more explicit or transparent, or provide more clarity to help a user better understand the financial statements?	Independent Auditor		X	X	X			X	
29. Have you expressed any concerns or offered comments to management with respect to how our presentation, including the notes or Management's	Independent Auditor							X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
Discussion and Analysis could be improved?									
30. Which accounting policies or significant business transactions do you think a stakeholder will have trouble understanding based on our disclosure? What additional information should we provide?	Independent Auditor							X	
31. Based on your auditing procedures, do you have any concerns that management may be attempting to manage cash flows, either properly or improperly? Have you noticed any biases as a result of your audit tests with respect to estimates?	Independent Auditor							X	
32. In which areas have you and management disagreed?	Independent Auditor		X					X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
33. Discuss your impressions of the performance of the CAE in terms of the completeness, accuracy, and faithfulness of the financial reporting process.	Independent Auditor							X	
34. Has the audit organization been engaged to provide any services besides the independent audit of which the audit committee is not already aware?	Independent Auditor		X					X	
35. How can management improve in terms of setting an appropriate tone at the top?	Independent Auditor							X	
36. Describe the ideas you have discussed with management for improving internal control over financial reporting.	Independent Auditor		X					X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions										
Question	Concept	Position							Comments	
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role		
37. Describe any situation in which you believe management has attempted to circumvent the spirit of GAAP, though it has complied with GAAP.	Independent Auditor		X						X	
38. Is there anything going on in the government entity with which you are uncomfortable, that you consider unusual, or that warrants further investigation?	Independent Auditor	X	X	X	X	X	X	X	X	
39. Describe your working relationship with the Government Entity Head.	Internal Environment		X	X	X			X		
40. If you were the partner, federal inspector general, other independent government auditor, or equivalent, what would you do differently?	Internal Environment	X	X	X	X	X		X		

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
41. How do you interface with the internal audit, and do you believe it is successful?	Internal Environment	X	X		X			X	
42. Has the independent auditor been engaged for any services other than the annual audit of the financial statements for which the audit committee is not already aware?	Independent Auditor	X	X	X	X	X		X	
43. What issues arose from any internal control documentation and validation efforts?	Internal Environment	X	X	X				X	
44. What aspects of the business put the most strain on the government entity's liquidity? On the government entity's capital position?	Financial Statements		X			X			

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
45. Which systems are the most difficult to use?	Internal Environment	X	X	X	X	X	X		
46. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?	Internal Environment	X	X	X	X	X	X		
47. What procedures or oversight are applied to manual journal entries that are proposed during the closing process?	Financial Statements		X			X			
48. Do the accounting and finance departments of the government entity have adequate personnel, both in numbers and quality, to meet all their obligations?	Internal Environment		X			X			

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
49. What are the most difficult challenges facing the finance organization today?	Internal Environment		X			X			
50. Which departments might benefit the most from additional personnel?	Internal Environment	X	X	X	X	X	X		
51. What were the personnel turnover rates in the accounting and finance teams for the last year?	Internal Environment		X			X			
52. Which of the government entity's areas of operations had the biggest unplanned loss this past year? The biggest gain? What, if any, changes do you believe need to be made in these areas?	Financial Statements	X	X	X	X	X		X	
53. Describe your working relationship with the heads of the respective business units.	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
54. What are the biggest risks facing the government entity in the next year? What steps do you think the entity should take to address those risks?	Internal Environment	X	X	X	X	X	X	X	
55. What are the biggest risks facing the government entity over the long term? What measures do you believe the entity should take to address those risks?	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
56. In light of the fact that you certified to your review of the financial statements that the financial statements do not contain any untrue statement of material fact or omit material facts, that they present fairly the results of operations, and that you take responsibility for the design of the internal control system, and have evaluated the effectiveness of the internal control system, what were your areas of concern? Are you satisfied that those areas have been resolved?	Financial Statements	X	X			X			
57. What procedures are applied to the review of manual journal entries made during the closing process, and to other entries that could be termed as a management override of the internal control over financial reporting?	Financial Statements		X			X		X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
58. If you were the Government Entity Head, how would you do things differently in the internal audit department?	Internal Environment			X				X	
59. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	Internal Environment			X					
60. Did you encounter any disagreements or difficulties between the internal audit function and the independent auditor in connection with the recently completed audit of the government entity's financial statements? How will you approach the financial statement audit differently next year?	Internal Environment			X				X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
61. What critical risks are being monitored by the internal audit function on a periodic or regular basis? How do you address the continuous auditing of these critical risks, and are automation and integrated system reporting assisting you in this effort?	Internal Environment			X					
62. Are you aware of any disagreements between the internal audit function and management?	Internal Environment	X	X	X	X	X	X	X	
63. What issues arose from any control documentation and validation efforts?	Financial Statements	X	X	X	X	X	X	X	
64. Are the information technology systems upon which you rely integrated, or is manual intervention required to integrate your systems?	Internal Environment		X			X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
65. What is your assessment of your performance?	Internal Environment	X	X	X	X	X	X	X	
66. What is your assessment of the CAE's performance?	Internal Environment	X	X		X	X	X	X	
67. How could the financial statements and related disclosures be improved?	Financial Statements	X	X	X	X	X		X	
68. Are you satisfied with the integrity of the information running through the systems in the government entity? How could technology improve the integrity of the information?	Internal Environment	X	X	X	X	X	X	X	
69. From what exposure does the government entity's firewall protect the entity's sensitive data?	Internal Environment	X		X	X		X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
70. If you had an unlimited budget, how would you spend funds to improve the government entity's internal controls including information architecture?	Internal Environment	X	X	X	X	X	X	X	
71. What do you consider your critical risk areas?	Internal Environment	X	X	X	X	X	X		
72. Describe your relationship with the Government Entity Head, CFO, and other key people in the accounting and finance teams.	Internal Environment	X	X	X	X	X	X	X	
73. Are manual journal entries identified and approved? Are they somehow brought to the attention of the CAE or other officers who did not participate in creating the journal entries?	Financial Statements		X	X		X		X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
Question	Concept	Position							Comments
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	
74. Is documentation updated every time there is a change to the internal controls process?	Internal Environment		X	X		X	X		
75. What role, if any, did your firm (OIG or similar government auditor) have in management’s documentation and assessment of the government entity’s internal control structure?	Independent Auditor							X	
76. What audit procedures are applied to manual journal entries that are proposed during the closing process, or to other journal entries that could be termed as management overrides of the internal control system around financial reporting?	Independent Auditor							X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions										
Question	Concept	Position							Comments	
		Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role		
77. Was any audit work not performed due to any limitations placed on you by management, such as any areas scoped out by management, or any restriction on fees that limited the scope of your work?	Independent Auditor			X					X	
78. Was the audit fee (if applicable) that you charged the government entity sufficient for the work that you performed?	Independent Auditor								X	
79. If you had had an unlimited audit fee, what additional work would you have performed?	Independent Auditor	X	X	X	X	X	X	X	X	

Chapter 13: Independent Auditor Communications with Audit Committee

Overview: The audit committee’s responsibility to oversee the government entity’s financial reporting and disclosures is increasingly challenging as the requirements and complexity of accounting standards continue to grow. This chapter is designed to help the audit committee fulfill its responsibilities with respect to oversight of the entity’s accounting and financial reporting, as well as oversight of the independent auditor (CPA firm or independent government audit organization), by addressing key required communications between independent auditors and audit committees. Clear communication among the audit committee, management, and the independent auditor (auditor) are essential to the effective discharge of these responsibilities. The required communications are based on AICPA auditing standards and generally accepted government auditing standards (GAGAS), and are intended to enhance the relevance, timeliness, and quality of communications between the auditor and the audit committee, and to foster constructive dialogue and enhanced understanding about significant audit and financial statement matters. While the communications addressed in this chapter are described as those between the audit committee and the independent auditor, part or all of the communication could be with the chair of the audit committee, the governing body, or others in the government entity who meet the description of “those charged with governance.”

Background

The Sarbanes Oxley Act of 2002 (the Act) contained a number of reforms intended to improve the integrity of accounting and financial disclosure. Although the Act applies to public companies, it led to changes in auditing standards for required communications between the auditor and the audit committee (or those charged with corporate governance) related to all financial statement audits regardless of industry. When those charged with governance are also involved in managing the entity, as is often the case with smaller entities, the auditor must consider whether communication with management, and especially management with financial reporting responsibilities, adequately informs those charged with governance. Therefore, the audit committee must ensure they have reached an understanding with the auditor about the appropriate levels of communication under those circumstances. Items noted herein as PCAOB or SEC requirements may be considered best practices although not required for government entities.

Objectives of Communications

The following sections summarize matters that may be communicated related to the audit of the government entity’s financial statements and are not meant to describe all topics that the auditor is communicating to the audit committee, only the minimum required communication. Broadly

speaking, the required communications¹ cover the following four objectives and other significant communications for the auditor's communications with the audit committee:

1. Communicate the auditor's responsibilities and establish terms of the firm's audit engagement
2. Inquire of the audit committee about matters relevant to the audit
3. Communicate audit strategy, scope, timing, and approach, including accounting policies, practices and estimates
4. Provide timely observations that are significant to the financial reporting process, including the independent auditor's evaluation of the quality of the entity's financial reporting

Timing of Communications

Audit committee communications should be made in a timely manner and prior to the issuance of the independent auditor's report. The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed. Many, however, consider it a "best practice" to also have the audit committee meet with the auditors during the audit planning process.

Communications may be made to only the audit committee chair if doing so helps with timeliness; however, all such matters should be communicated to the audit committee prior to the issuance of the auditor's report. Although this section focuses primarily on communications by the auditor, communications among management, the auditor, and the audit committee are important in assisting the committee fulfill its responsibility to oversee the financial statement process and other matters of governance interest. Communications by the auditor do not relieve management of this responsibility.

1. Terms of the Independent Auditor's Audit Engagement

Terms of the audit and engagement letter. The independent audit organization must establish an understanding of the terms of the engagement with the audit committee, and, in an engagement letter must include the objectives of the audit, the responsibilities of the auditor, and the responsibilities of management. It is important for the audit committee to understand the purpose of the audit and its limitations, and the auditor's engagement terms should clearly describe the auditor's responsibilities under general accepted auditing standards or generally accepted government auditing standards. It is important to inform the audit committee that the external audit is not a substitute for a robust internal audit department or function, and does not relieve management of their duty to design and maintain adequate internal control. Consideration should be given to having the audit committee chair sign the engagement letter after committee approval.

Discussions with management in connection with appointment or retention. The auditors must discuss with the audit committee any significant issues that the audit firm discussed with

¹ AU-C sec. 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*).

management in connection with the independent auditor's appointment or retention, including any significant discussions regarding the application of accounting principles and auditing standards.

Independence. Generally accepted auditing standards require independence for all audits. Although the auditor's report affirms the auditor's independence, the auditor should communicate to the audit committee circumstances such as financial interests, business or family relationships, or non-audit services provided that, in the auditor's judgment, may be thought to bear on independence and that the auditor considered in reaching the conclusion that independence has not been impaired. Many government entities require audit committee approval prior to engagement of the independent auditor for any additional audit fees or for non-audit related services to ensure the committee is fully aware of any additional fees or services provided by any sector of the independent auditors (for example, information technology consulting).

2. Inquiries About Matters Relevant to the Audit

The independent auditor must ask the audit committee whether it is aware of matters relevant to the audit including, but not limited to, violations or possible violations of laws or regulations or risks of material misstatement, including inquiries related to fraud risk. Although not required, an independent auditor may choose to seek a representation letter from the audit committee addressing such matters.

The auditor may also discuss with the audit committee his or her view about roles and responsibilities between those charged with governance and management, how those charged with governance oversee the effectiveness of internal control and the detection or possibility of fraud, significant communications with regulators, or other matters deemed relevant to the audit of the financial statements.

PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, requires the audit firm to make specific inquiries of the audit committee, management, internal audit, and others within the entity regarding their views of fraud risks within the entity. The specific required inquiries of the audit committee include the committee's views about fraud risks in the entity; whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the entity; whether the audit committee is aware of tips or complaints regarding the entity's financial reporting (including those received through the internal whistleblower program, if such a program exists), and if so, the audit committee's responses to such tips and complaints; and how the audit committee exercises oversight of the entity's assessment of fraud risks and the establishment of controls to address fraud risks.

3. Audit Strategy, Timing, and Approach

Communicating the Audit Strategy and Timing. As part of communicating overall audit strategy, the auditor must specifically communicate the timing of the audit, discuss significant risks identified during risk assessment procedures, and, if applicable, discuss the following:

- The nature and extent of specialized skills or knowledge required to perform procedures or evaluate results related to significant risks

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- The approach for internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- If applicable, the extent to which the independent external auditor will rely on the government entity's internal auditors or other parties in connection with the audit
- The names and responsibilities of others not employed by the independent auditor who performs audit procedures
- The basis for the auditor's determination that it can serve as the principal auditor, if significant parts of the audit are performed by other auditors
- The concept of materiality in planning and executing the audit
- Confirmation of the appropriate person or people in the entity's governance structure with whom to communicate

Critical Accounting Policies and Practices. The auditor must inform the audit committee of all critical accounting policies and how they are applied in the entity. Critical accounting policies are those that are both most important to the portrayal of the entity's financial condition and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. The audit committee should expect the following communications:

- All critical accounting policies, including those that applied for the first time during the year, changes in accounting policies, or accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to a specific industry
- The reason certain policies and practices are considered critical
- How those accounting policies are applied in the entity
- Policies and practices the entity used to account for significant unusual transactions
- The effect on the financial statements or disclosures of critical accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus, or diversity in practice, such as revenue recognition, multi-year pledges, reserves, planned giving gifts, and alternative investments
- Whether these critical policies are included in the financial statements

Critical Accounting Estimates. Critical accounting estimates are an integral part of the financial statements prepared by management. These estimates are based on management's judgments (which are normally based on management's knowledge and experience about past and current events), and assumptions about future events.

The auditor should address the following issues with the audit committee:

- a. The process used by management to develop critical accounting estimates

- b. Management's significant assumptions in developing critical accounting estimates that have a high degree of subjectivity
- c. For any significant changes to (a) or (b), a description of management's reasons for the changes and the effects of the changes on the financial statements
- d. The basis for the auditor's conclusion about the reasonableness of those estimates

In many cases, management will communicate with the audit committee regarding the entity's accounting policies, practices, and estimates. The independent auditor participates in the discussion and confirms that management has communicated the required matters adequately.

4. Evaluation of the Quality of the Government Entity's Financial Reporting

The auditor must communicate judgments about the quality, not only factual information and conclusions regarding the acceptability of the government entity's accounting policies and practices. The communication should be tailored to the entity's specific circumstances and include evaluation of the following:

- **Significant Accounting Policies and Practices:** Auditor's conclusions about the qualitative aspects, including the auditor's assessment of management's disclosures. Communication must include any situation in which the auditor identified bias in management's judgments about the amounts or disclosures, and evaluation of differences between estimates supported by audit evidence and estimates included in the financial statements.
- **Critical Accounting Estimates:** The basis for auditor's conclusions regarding estimates, judgments and uncertainties underlying financial statements and conclusions.
- **Significant Unusual Transactions:** The auditor's understanding of the business rationale for significant unusual transactions.
- **Financial Statement Presentation:** Evaluation of whether presentation of financial statements and disclosures are in conformity with the applicable financial reporting framework (in other words, FASAB or GASB).
- **New Accounting Pronouncements:** If applicable, any concern regarding significant effects on future financial reporting related to management's anticipated application of accounting pronouncements that have been issued but are not yet effective.
- **Alternative Accounting Treatments:** Permissible alternative accounting treatments related to material items, ramifications thereof, and the treatment preferred by the auditor.

5. Other Significant Communications

In addition to communications about the quality of financial reporting noted in Section 4, the auditor must communicate, when relevant, the following regarding the audit process and results.

Responsibility for Other Information. Although the notes to the financial statements are an integral part of the financial statements and therefore are included in the scope of the auditing

procedures, other information prepared by management that may accompany the entity's financial statements is not necessarily included in the scope of the auditing procedures. The auditor should communicate his or her responsibility for such information, and the results of any related procedures performed.

Matters for Which the Auditor Consulted. The auditor should communicate any difficult or contentious matters for which the auditor consulted outside the engagement team, which may include the independent auditor organization's national office, industry specialists, or an external party.

Matters for Which Management Consulted. Sometimes, management of the entity may consult with other independent accountants about significant accounting or auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss with the audit committee his or her views about the significant matters that were the subject of the consultation.

Material Written Communications. The auditor should notify the audit committee of other material communications with management, such as the management letter, schedule of unadjusted differences, and written representations the auditor is requesting from management.

Uncorrected and Corrected Misstatements. The auditor should inform the audit committee about all corrected and uncorrected misstatements arising from the audit that could, in the auditor's judgment, have a significant effect on the entity's financial reporting process. The audit engagement team tracks proposed adjustments during the audit, except for those that are clearly trivial, for discussion with management. Management evaluates those proposed adjustments and determines whether or not to record the adjustments.

The auditor's communications should

- inform the audit committee about adjustments arising from the audit that could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process;
- address whether or not the proposed adjustments were recorded, and the implications of any misstatements on the entity's financial reporting process;
- address whether the adjustments to accounts and disclosures may not have been detected except through the auditing procedures performed (meaning that the entity's own internal control system did not detect the need for the adjustment); and
- provide the schedule of uncorrected misstatements related to both accounts and disclosures, and support for the determination that the uncorrected adjustments were immaterial, including qualitative factors.

Departure from the Auditor's Standard Report. The following matters related to modifications of the auditor's standard report should be communicated:

- The reasons for the modification and the wording of the report, if the auditor expects to modify the opinion in the auditor's report

- The reason for and the wording of the explanatory language if the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report

Disagreements With Management. Disagreements may arise between the auditor and management over the application of accounting principles to specific transactions and events, as well as the basis for management's judgments about accounting estimates, or the scope of the audit or disclosures to be made in the financial statements or footnotes. Differences of opinion based on incomplete facts or preliminary information that are later resolved are not considered disagreements for this purpose.

The auditors should communicate any disagreements with management, whether or not satisfactorily resolved, about matters that could be significant, individually or in the aggregate, to the government entity's financial statements or the auditor's report.

Difficulties Encountered in Performing the Audit. The auditor should inform the audit committee about any significant difficulties encountered in working with management and staff during the audit. Examples include, but are not limited to, an unreasonably brief time to complete the audit, delays or unavailability of needed personnel or information, or unexpected extensive effort required by the auditor to obtain sufficient audit evidence. These difficulties could represent a scope limitation that may result in a modified auditor's opinion, or the auditor's withdrawal from the engagement.

Going Concern. The auditor must communicate those conditions and events the independent auditor has identified that, when considered in the aggregate, lead the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, along with the basis for the conclusion. The auditor must also communicate the effects on the financial statements and on the auditor's report.

Other Matters. Any other matters arising from the audit that are significant to the oversight of the entity's financial reporting process should be communicated, including any complaints or concerns regarding accounting or auditing matters that have been conveyed to the audit firm.

Interim Reviews. The audit committee should expect communications from the auditor related to interim reviews to include

- an engagement letter communicating the terms of the engagement to review interim financial information.
- material weaknesses or significant deficiencies, if any, of which the auditor becomes aware,
- other significant matters impacting the interim financial information, and
- a schedule of uncorrected misstatements, if any.

Illegal Acts

The auditor has the responsibility to assure himself or herself that the audit committee is adequately informed about illegal acts that come to the auditor's attention (this communication

need not include matters that are clearly inconsequential). The communication should describe (1) the act, (2) the circumstances of its occurrence, and (3) the effect on the financial statements.

What is an illegal act for purposes of this communication? Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines it as “violations of laws or government regulations attributable to the entity, or acts by management or employees on behalf of the entity. Illegal acts do not include personal misconduct by the entity’s personnel unrelated to their business activities.”

When performing a GAGAS financial audit, the auditor should extend the AICPA requirements pertaining to the auditor’s responsibilities for laws and regulations to also apply to compliance with provisions of contracts or grant agreements. Also, if the auditor becomes aware of abuse that could be material to the financial statements, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements. Auditors should discuss with the audit committee any insight into potential areas or transactions that could be considered regarding violations of contracts or grant agreements or abuse. The audit committee may also want to initiate a discussion about potential areas of abuse with the auditor during the engagement letter process. See paragraphs 4.07-4.09 of the *Government Auditing Standards* (the “Yellow Book”) for more information about the additional obligations of auditors regarding the investigation of abuse.

Internal Control Matters

See also chapter 8, “Internal Control: Guidelines and Tool for the Audit Committee,” in this toolkit, which defines key terms used in the assessment of internal controls.

The auditor may communicate in writing to management and the audit committee all significant deficiencies and material weaknesses observed relating to the government entity’s internal control in the conduct of a financial statement audit. These matters should be discussed with the audit committee because they represent significant deficiencies in the design or operation of the internal control system, which could adversely affect the entity’s ability to initiate, record, process, and report financial data consistent with the management’s assertions in the financial statements.

The auditor must also communicate to management, in writing or orally, control deficiencies that are not significant. These may be communicated with other observations that may be of potential operational or administrative benefit, including recommendations for improving internal control. This is typically provided in the form of a management letter, or may be combined with required communications noted in the previous paragraph.

Management may be required by a regulator or grantor to prepare a written response to the auditor’s communication regarding significant deficiencies or material weaknesses identified during the audit. These responses may include a description of corrective action to be taken, plans to implement new controls, or a statement indicating that management believes the cost of correcting the deficiency would exceed the benefits to be derived from doing so.

Fraud

See also chapter 9, “Fraud and the Responsibilities of the Audit Committee,” in this toolkit.

AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), requires that the independent auditor bring any evidence of fraud to the attention of the appropriate level of management (generally seen as one level higher than the level at which a suspected fraud may have occurred), even in the case of an inconsequential fraud, such as a minor defalcation by a low-level employee. The independent auditor should reach an understanding with the audit committee regarding nature and scope when an inconsequential fraud committed by a low-level employee should be brought to the audit committee's attention. Fraud involving senior management, and any fraud, whether caused by senior management or other employees, that causes a material misstatement of the financial statements must be reported to the audit committee by the independent auditor. It is a best practice for the auditor to disclose any perceived fraud, illegal acts, violation of provisions of contracts or grant agreements, and potential abuse to the audit committee, regardless of materiality, to ensure management's commitment to a sound internal control environment.

Chapter 14: Responding to the Identification of a Material Weakness—A Checklist for the Audit Committee

Overview: The guidance in this chapter is designed to familiarize the audit committee of a government entity that has received a report on its internal control over financial reporting from its independent auditor that identifies a material weakness. The first half of the chapter summarizes the internal control evaluation requirements; the second half includes steps the audit committee should take if faced with this situation. See also chapter 8, “Internal Control: Guidelines and Tool for the Audit Committee,” in this toolkit for a more comprehensive discussion of the audit committee’s oversight role with respect to internal control.

Background

A key area for audit committee oversight is to review and provide input on the government entity’s internal control framework. To obtain reasonable assurance with respect to the organization’s internal control framework, the audit committee

- reviews and provides advice on the organization’s system of internal control.
- receives reports on all matters of significance resulting from work performed by those who provide financial and internal control assurance to the governing body or the head of the government entity.

Internal Control Evaluation Requirements

In addition to AICPA requirements, reporting on financial statement audits performed in accordance with Generally Accepted Government Auditing Standards (GAGAS) also includes reports on internal control over financial reporting. These reports should include a description of the scope of the auditors’ testing of internal control over financial reporting, any significant deficiencies and material weaknesses identified; and whether the tests performed provided sufficient, appropriate evidence to support opinions on the effectiveness of internal control.

The auditor should be required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit.

When auditors identify such findings, they should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The auditor may have an additional engagement to report on the effectiveness of an entity’s internal

control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*). This section does not address an AT section 501 engagement.

To understand control deficiencies best, it is important for audit committee members to understand certain key terms. Review the section “Key Terms in Internal Control Over Financial Reporting Control” in chapter 8, “Internal Control: Guidelines and Tool for the Audit Committee,” in this toolkit for definitions and explanations of the terms *control deficiency*, *significant deficiency*, and *material weakness*.

Responding to the Identification of a Material Weakness

When a GAGAS financial audit is performed, if the auditors’ report discloses deficiencies in internal control, auditors obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations, as well as any planned corrective actions. The audit committee should be engaged in the review and approval of that response and any subsequent corrective action plan. The checklist in this section provides guidance and questions which the audit committee can ask as part of its review.

Additional Resources

Government entities are not subject to SEC requirements. CPA firms or government auditors performing audits of government entities are not subject to PCAOB rules. Government audit committees may want to refer to public company requirements as a resource. The following are various forms of guidance applicable to public companies that may be beneficial to audit committees and management:

- PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
- PCAOB Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
- GAO’s *Standards for Internal Control in the Federal Government* at <http://www.gao.gov/assets/670/665712.pdf>
- OMB Circular A-123, *Management’s Responsibilities for Internal Control* at https://www.whitehouse.gov/omb/circulars_a123_rev

Steps the Audit Committee Can Consider If Faced With an Adverse Report on Internal Control

Instructions for using this tool: In a government entity facing a negative report on internal control, those charged with governance should take steps to ensure that (1) any material weakness(es) in internal control are swiftly corrected, and (2) key stakeholders are assured that corrective action has been taken.

Note: This tool has been prepared purposefully for broad application. No single tool of a practical length could be developed to address all different situations that could cause a negative report on an organization’s internal controls over financial reporting. When faced with a negative report, those charged with governance should use this tool in the context of the deficiencies noted. As with all tools of this type, users must apply their own insight and judgment to the situation to maximize benefits.

It is important for those charged with governance to understand the material weakness(es) giving rise to the negative report. They should meet with the management team, internal auditors, and the independent external auditors (CPA firms or independent government auditors), and understand the issue from each perspective to make fully informed recommendations and decisions. The following are sample questions to help guide the audit committee through this process.

Sample Questions	Comments
Management Team	
1. Interview members of the management team, including the chief financial officer (CFO), controller, and other management, as necessary, closer to the situation, about the weakness(es). You should consider conducting these interviews in an executive session.	
<ul style="list-style-type: none"> Who identified the weakness, and in what context, such as the annual financial statement audit, routine internal audit or management review was it identified? 	
a. Management	

Sample Questions	Comments
b. Internal audit	
c. Independent auditors	
d. Another third party	
<ul style="list-style-type: none"> • What are the nature and root cause of the control failure? 	
<ul style="list-style-type: none"> • How long has the weakness existed? 	
<ul style="list-style-type: none"> • What are the financial statement implications of the control failure? Are there regulatory or compliance implications? Will this weakness become public information? Are there reputational implications? Could the control failure have been the result of fraud? 	
<ul style="list-style-type: none"> • If the root cause is systemic, such as turnover, were other controls affected? Are there other controls in the area that may mitigate for the control that failed? 	
<ul style="list-style-type: none"> • What is management’s plan and timing to correct the material weakness? 	
<p>2. Explore with the management team how much was known about the weakness(es) when the Government Entity Head and CFO prepared the financial statements and made certifications regarding those financial statements (if applicable).</p>	
<ul style="list-style-type: none"> • Consider any implications to these financial statements in light of the material weaknesses noted. 	

Sample Questions	Comments
3. In subsequent years, ask the management team for an update on the status of the current year weakness.	
Those Charged with Governance	
1. Discuss the material weakness with those charged with governance.	
<ul style="list-style-type: none"> Are you comfortable with management's assertions about the material weakness and the corrective action plan? Determine whether internal audit, management, or a third party conducted any recent testing in the area and understand the results of their testing. 	
<ul style="list-style-type: none"> Do you have concerns that fraud or an illegal act was involved in the material weakness? 	
<ul style="list-style-type: none"> Has management been responsive to findings and recommendations in the past? Has management been cooperative and open during the review of the material weakness? 	
Independent Auditor	
1. In executive session, discuss the findings, implications, and recommendations with the independent external auditor and internal auditors.	
<ul style="list-style-type: none"> Determine whether the independent external auditor's (or internal auditor's, if applicable) result is consistent with the result of management's assessment of internal controls. 	

Sample Questions	Comments
<p>2. Collect information from the independent external auditor based on his or her knowledge of internal controls and experiences with other clients:</p>	
<ul style="list-style-type: none"> • Has the weakness been discussed with the entity in the past? Does management have the proper tone at the top regarding internal controls? 	
<ul style="list-style-type: none"> • Is this weakness a result of a unique situation at the entity? 	
<ul style="list-style-type: none"> • Is this weakness a result of a unique situation in the related industry or government sector? 	
<p>3. After meeting with the management team, those charged with governance and the independent external auditor (or internal auditor, if applicable), address whether the weakness(es) could have resulted from an illegal act.</p>	
<ul style="list-style-type: none"> • Consider the need to conduct a formal investigation in the area to determine if the weakness(es) resulted from an illegal act. 	
<ul style="list-style-type: none"> • Consider the need to engage a forensic accountant or auditor to review the situation if any fraud or illegal activity is suspected. 	
<ul style="list-style-type: none"> • If an illegal act is suspected, work expeditiously to determine if such an act occurred. If confirmed, notify those charged with governance or other relevant parties. 	

Sample Questions	Comments
4. Consult experts from outside the entity about the weakness(es) and the steps necessary to be taken to correct it or them.	
5. Work with management to develop a plan to correct the weakness(es):	
<ul style="list-style-type: none"> • Identify metrics that can be reported to internal and external parties on the progress being made in correcting the weakness(es). 	
6. Provided the entity has corrected its internal control weakness successfully, consider whether to engage the independent external auditor to issue a separate report on the elimination of the weakness in internal control over financial reporting.	
7. In subsequent years, ask the independent external auditor for an update on the status of the current year weakness.	
Additional considerations	
1. Review with management its plan to respond to audit findings, conclusions and recommendations.	
2. Review with management its plan to reassure key stakeholders about the findings, conclusions and corrective action plans.	
3. Review with management its strategy with reporters who might be interested in the government entity's plans to	

Sample Questions	Comments
correct the weakness(es) noted (if applicable).	
4. Inquire of management if they have considered other potential implications of the findings identified. For example, consider whether the findings identified could have an impact on:	
<ul style="list-style-type: none"> • Compliance with debt covenants 	
<ul style="list-style-type: none"> • Grant requirements 	
<ul style="list-style-type: none"> • Other parties 	

Part III: Performance Evaluation

Chapter 15: Evaluating the Internal Audit Function: Questions to Consider

Overview: The audit committee, including the chief audit executive (CAE), has the responsibility to oversee and evaluate the internal audit function. This includes ensuring the internal audit function is independent and objective in order to perform its work effectively across the government entity to provide the audit committee with an assessment on the state of the government entity’s risk, control, governance, and monitoring activities. In discharging this responsibility, the audit committee should answer a series of questions about the quality and performance of the internal audit function, and should obtain input from others in the government entity including management and independent auditor.

Note: The Institute of Internal Auditors (IIA) establishes standards for the internal audit profession and provides certifications in internal auditing. The International Standards for the Professional Practice of Internal Auditing (standards) provide guidance for the conduct of internal auditing at both the organizational and individual auditor levels. Internal audit functions that commit to adhering to these standards are required to establish a Quality Assurance and Improvement program that includes both ongoing and periodic internal quality assessment reviews (QARs) and undergo an external QAR a minimum of once every five years. If required or elect to conduct audits in accordance with *Government Auditing Standards*, the external peer review is required at least once every three years.

Instructions for using this tool: The sample questions included in this tool are only a starting point for evaluating the performance and effectiveness of the internal audit function. Audit committee members should ask follow-up questions as appropriate and required.

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
1. Has the internal audit charter been evaluated at least annually and presented to senior management and the audit committee for approval?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
2. Has the CAE assessed whether the internal audit activity's purpose, authority, responsibility, as defined by the internal audit charter, is adequate to enable the activity to meet its objectives?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. <i>a.</i> Does the internal audit function maintain a quality assurance and improvement program?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>b.</i> Has the internal audit function conducted the external QAR (either a full external assessment or a self-assessment with an independent external validation) required by IIA standards in the last five years or every three years if conducting the audits in accordance with GAGAS?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>c.</i> Did the CAE discuss the form and frequency of external assessment; and the qualifications and independence of the external assessor or assessment team, including any potential conflict of interest with the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>d.</i> Has the CAE at least annually discussed the results of the quality assurance and improvement program with the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>e.</i> Has the CAE disclosed any nonconformance with the standards?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
<p>4. Is the CAE reporting relationship appropriate to provide adequate independence to enable the internal audit activity to meet its responsibility? Government entity independence is effectively achieved when the CAE reports functionally to the audit committee and administratively to the Government Entity Head.</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>5. Does the government entity's executive leadership support and value the work performed by the internal audit function?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>6. If the internal audit function is outsourced:</p> <p><i>a.</i> Are the areas outsourced appropriately?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p><i>b.</i> Is sufficient monitoring in place to assure the quality of the outsourced function?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>7. Is the internal audit function independent and are the internal auditors objective when performing their work?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>8. Is the internal audit function's size, budget, and structure adequate to meet its established objectives?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>9. Has the internal audit function discussed all scope limitations and access issues?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<p>10. Do the internal auditors feel comfortable raising issues that could reflect negatively on management? Are matters that warrant audit committee attention brought forth on a timely basis?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
11. Are the technical knowledge, including information technology knowledge, and experience levels of the internal audit function staff sufficient to ensure that duties are performed appropriately?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Is the internal audit function's work planned appropriately to address the risks of the government entity and focused on the right areas/topics of high risk, judgment, and sensitivity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Has the internal audit function solicited the input of senior management and the audit committee in its planning?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
14. Does the internal audit function's work encompass a good balance between operational and financial areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15. Does the internal audit function appear to be using its time and resources effectively and efficiently in performing the annual internal audit plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
16. Relating to the annual independent audit, was the internal audit function involved?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
a. If so, was the internal auditor function involvement effective?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. If so, were activities adequately coordinated with the external auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
17. Are reports accurate, objective, clear, concise, constructive, complete, and timely; and supported by sufficient, reliable, relevant, and useful information?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
18. Did the internal audit function provide constructive observations, implications, and recommendations in areas needing improvement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
19. Does management respond in an appropriate and timely fashion to significant recommendations and comments made by the internal audit function?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
20. Did the internal audit function address any feedback satisfactorily from the audit committee or senior management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
21. Does the internal audit function stay abreast of relevant updates such as green book/COSO framework, yellow book/GAAP, and other relevant governmental regulations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
22. Does the internal audit function have adequate on-boarding and training programs to incorporate new staff members quickly?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
23. Does the internal audit function have continuing education programs and leadership training to grow and develop staff?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
24. Please share any additional thoughts that could further improve the internal audit function's effectiveness and efficiency.				
Other Comments, Further Questions				

Chapter 15: Evaluating the Internal Audit Function

Evaluation of Internal Audit Team	Yes	No	N/A	Comments

Chapter 16: Evaluating the Independent Auditor: Questions to Consider

Overview: As a best practice, the audit committee has the responsibility to hire, compensate, evaluate, and terminate the independent auditor (auditor). In discharging this responsibility, the audit committee should answer a series of questions about the quality and performance of the auditor, and should obtain input from others in the government entity, including management and internal audit.

For some governmental entities, the independent auditor may be from another government entity. If this is the case, while the audit committee and government entity management would not have the authority to hire and terminate the independent auditor, most of these questions would still be applicable in being able to provide feedback around the performance and effectiveness of the independent auditor.

Instructions for using this tool: The sample questions included in this tool are only a starting point for evaluating the performance and effectiveness of the auditor. Audit committee members should ask follow-up questions as appropriate and required.

Questions for Audit Committee Members

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
Quality of Resources and Services				
1. Does the audit team have the knowledge and skills necessary to meet the government entity’s audit requirements, including specialized skills and knowledge of the specific government sector or enterprise? (Consider abilities of the partner(s), manager(s), director(s), and fieldwork leaders, and level of access to specialized expertise).	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
2. Does the auditor identify and discuss the appropriate risks considered in the planning of the audit, including tone at the top, fraud, governance matters, and risk of management override of controls?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are you satisfied with the auditor’s planning, execution, and communication related to the audit, including the scope, nature, extent/sampling, and timing?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does the audit team leverage the work performed by internal audit, management, or government auditors (e.g. GAO/OIG) for the audit or reporting of internal control over financial reporting and compliance when determining the work needed for the audit of the financial statements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Do the auditor’s written reports to the committee cover all appropriate issues adequately, giving consideration to requirements such as GAAP (that is, FASAB or GAAS), and GAGAS (if applicable) as well as elements required by the auditor contained in the committee charter?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. If applicable, are the audit fees reasonable and sufficient in light of the quality of services provided, size and complexity of the government entity, and the risks facing the government?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
7. Has the auditor presented the committee with the audit organization's latest AICPA peer review report (or any other required peer review report such as the PCAOB inspection report)? If findings are noted with the report(s), has the auditor communicated the resolution? See chapter 5 for additional questions to ask when reviewing the report.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Has the committee requested that the auditor describe the audit organization's annual internal quality assurance process that is performed in between the required AICPA peer review (or any other required peer review)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Quality of Communications				
9. Does the auditor communicate issues openly, and in a complete and understandable way?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
10. Does it appear that the auditor is free from undue influence by management, and that the auditor is comfortable raising issues that would reflect negatively on management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. Does the auditor take advantage of an executive session appropriately, if permitted by law, by discussing any sensitive issues professionally, candidly, and in a timely manner?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Does the auditor communicate, or ensure that management communicates, relevant developments in accounting principles and auditing standards that could affect the government entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
13. Does the auditor volunteer constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the government entity’s internal controls over financial reporting?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Independence and Objectivity				
14. Considering all audit-related and non-audit services performed by the auditor, are you satisfied that the auditor remains independent and objective both in fact and appearance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15. Are you satisfied that the auditor reports all matters openly to the committee that might be thought to bear on the audit organization’s independence?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
16. Based on the open and informative nature of the auditor’s answers to questions posed by the committee, do you feel confident that the auditor maintains appropriate objectivity and professional skepticism?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Final Evaluation				
17. Based on your assessment, would you rehire the auditor to conduct future audits? If yes, what changes would you make, if any? If no, why not?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Questions for Management and/or Internal Audit

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
<p>In addition to the questions above, following are questions the audit committee may ask of government entity's personnel such as the CAE, Government Entity Head, CFO, controller, or general counsel, to assist in evaluating the performance of the auditor.</p>				
1. Does the auditor work with internal audit to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. <i>a.</i> Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>b.</i> Are you satisfied with the performance of the engagement leadership assigned, including the partner(s), manager(s), director(s), and fieldwork leaders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Was the work with the auditor conducted in the spirit of professionalism and mutual respect?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. <i>a.</i> Are you aware of any other information that might impair the independence of the independent auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>b.</i> Are you aware of any individuals on the audit team who might not be independent with respect to the government entity for whatever reason?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. <i>a.</i> If the choice were yours, would you hire the independent auditor to conduct future audits?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
<i>b.</i> If yes, what changes would you make, if any? If no, why not?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Further Questions or Other Comments				

Chapter 17: Conducting an Audit Committee Self-Evaluation: Questions to Consider

Overview: The audit committee should conduct an annual self-evaluation to determine its performance and effectiveness. Audit committee members should answer a series of questions independently to complete their self-evaluations. The entire audit committee should discuss the answers and plan for further action as appropriate prior to starting the next audit committee year.

Instructions for using this tool: The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. These questions should be completed anonymously by each audit committee member prior to the audit committee meeting, and the entire committee should discuss the responses.

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
1. Does the committee have a charter that covers all standard best practices? For a listing of standard best practices for an audit committee charter, see chapter 2, “Audit Committee Charter Matrix,” in this toolkit.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Has the charter been reviewed annually?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is the audit committee charter used to guide the committee’s efforts and agenda?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Have all elements of the committee’s responsibilities, as delineated in the audit committee charter, been covered throughout the fiscal year?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
5. Are the members educated appropriately on the government entity, its organizational structures, governance and internal control environment, and current hot topics, as well as the government entity’s risk profile?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Is there a member that is truly independent of the government entity, such as an appointed public member?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Is there a sufficient mix of necessary skill sets and knowledge among the committee members, including acumen around financial reporting, risk assessments, internal controls, and systems?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Do the committee members actively promote and advance the ethical values of the government entity? For example, do they speak regularly to the importance of ethical behavior and compliance with such guidelines? Do they insist or demonstrate the commitment to holding employees accountable for ethical lapses?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Do committee members participate in some form of continuing education to stay abreast of changes in the relevant financial accounting and reporting, regulatory, and ethics areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
10. Are the committee’s meeting packages complete?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. Are the meeting packages given to committee members with enough lead time to allow for sufficient review?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
12. Do the meeting packages include the right information to allow meaningful discussion?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Are the committee meetings well organized, efficient, effective, and of the appropriate length?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
14. Do the committee meetings occur often enough to allow discussion of issues that are relevant to and consistent with the committee's responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15. Do the minutes and reports to the full governing body reflect the significant activities, actions, and recommendations of the committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
16. Does the committee have open access to management, internal audit, and independent auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
17. Do committee members have open, honest, and effective communication with management, the internal auditors, and the independent auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
18. Is the committee able to challenge management, the internal auditors, and the independent auditors with its own view on issues as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
19. Are differences of opinion on issues resolved to the satisfaction of the entire committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
20. Is the committee aware of the difference between giving advice, making requests, and making decisions that appropriately are management's responsibility?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
21. Does the committee successfully respect these differences?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
22. Does the committee have a clear definition of the services the independent auditors are allowed to perform in order to maintain independence?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
23. Does the committee approve all allowed services of the independent auditors in advance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
24. Does the committee review the independent auditors' reports:	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
a. At least annually?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. To ensure the auditors maintain their independence?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
25. Is the committee aware of the last time the independent audit firm or lead partner was rotated and is the committee considering a future rotation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
26. If applicable, does the committee provide input regarding the hiring and evaluation of the Chief Audit Executive (CAE)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
27. If applicable, does the committee assess the adequacy of the budget and staffing level of the internal audit function on an at least annual basis?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
28. Does the committee directly ask the CAE whether management is fully cooperating and supporting the performance of audit activities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
29. Do individual members of the committee initiate private discussions with the CAE regarding the adequacy of the internal audit function budget and the cooperation of management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
30. Does the committee provide feedback to the CAE?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
31. Does the committee notify the governing body of its assessment regarding the adequacy of the budget and staffing to ensure the quality and objectivity of the internal audit team?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
32. Does the committee receive the appropriate level of information to evaluate the soundness of the government entity's internal control environment?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
33. May the committee engage outside experts as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
34. Does the committee conduct executive sessions in a manner that offers a safe haven to the individual?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
35. During executive sessions, does the committee ask tough and necessary questions, evaluate the answers, and pursue issues that might arise to a satisfactory resolution?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
36. Do the committee members challenge the chair as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
37. Does the committee receive constructive feedback from management, internal and independent auditors, and peer groups?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

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Audit Committee Self-Evaluation	Yes	No	N/A	Comments
38. Do the committee members feel that the government entity's overall governance and internal controls, including financial reporting processes, are stronger as a result of the committee members' participation and actions on the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Further Questions or Other Comments				

Part IV: Other Tools

Chapter 18: Enterprise Risk Management: A Primer on the COSO Framework

Overview: Enterprise risk management is an attempt to manage risk in a comprehensive manner that is aligned with the strategic direction of the organization and integrated with the everyday management of the government entity. Many government entities, governing bodies, and audit committees view risk management from this strategic perspective, and consider risk management oversight to be a critical element of governance.

This chapter is intended to give governing bodies an overview of enterprise risk management, its opportunities and limitations, the relationship between enterprise risk management and internal control, and the roles and responsibilities for risk management in the government entity. Enterprise risk management is a management responsibility, subject to oversight of the governing body. It does not involve external audit attestation.

Audit committee role: It should be noted that there is no regulatory mandate for implementation of enterprise risk management. However, if and when implemented, this committee should assume oversight of the process.

Enterprise Risk Management Primer—Basics of ERM and Its Relationship to Internal Control

In September 2004, the Committee of Sponsoring Organizations (COSO)¹ of the National Commission on Fraudulent Financial Reporting of the Treadway Commission published a document called *Enterprise Risk Management—Integrated Framework*,² (ERM framework), which defined enterprise risk management as

... a process, effected by an entity's board of directors, management, and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

The ERM framework is geared toward achieving an entity's objectives, set forth in four categories:

1. Strategic: high-level goals, aligned with and supporting its mission
2. Operations: effective and efficient use of its resources

¹ The Committee of Sponsoring Organizations consists of the American Institute of CPAs (AICPA), the Institute of Management Accountants (IMA), the Institute of Internal Auditors (IIA), Financial Executives International (FEI), and the American Accounting Association (AAA).

² The COSO publication *Enterprise Risk Management—Integrated Framework* (Product Code Number 990015), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of this publication are used to support the continuing work of COSO.

3. Reporting: reliability of reporting
4. Compliance: compliance with applicable laws and regulations

The COSO Enterprise Risk Management Framework consists of the following eight interrelated components:

1. *Internal Environment:* The internal environment sets the foundation for how risk is viewed and addressed by an entity's people, including risk philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
2. *Objective Setting:* Objectives must exist before management can identify potential risks affecting their achievement. Enterprise risk management ensures that management has in place a process to set objectives, that the chosen objectives support and align with the entity's mission, and that they are consistent with its risk appetite.
3. *Event Identification:* Internal and external events affecting the achievement of an entity's objectives must be identified, distinguishing between risks and opportunities.
4. *Risk Assessment:* Risks are analyzed, considering likelihood and impact, as a basis for how they should be managed. Risks are assessed on an inherent and residual basis.
5. *Risk Response:* Management selects risk responses—avoiding, accepting, reducing or sharing risk—developing a set of actions to align risks with the entity's risk tolerances and risk appetite.
6. *Control Activities:* Policies and procedures are established and implemented to help ensure the risk responses are carried out effectively.
7. *Information and Communication:* Relevant information is identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
8. *Monitoring:* The entire ERM process is monitored, and modifications are made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

Enterprise risk management is not a serial process, but a multi-directional iterative process, with the eight components impacting each other. Likewise the eight components will not function identically in every government entity. Application in small and medium-sized government entities is likely to be less formal and less structured.

The components are the criteria for the effectiveness of enterprise risk management. When each of the eight components is determined to be present and functioning effectively, and risk has been brought within the government entity's risk appetite, management and the governing body have reasonable assurance that they understand the extent to which each of the four categories' objectives is being achieved by the government entity.

Relationship Between COSO Enterprise Risk Management—Integrated Framework and Internal Control—Integrated Framework and Standards for Internal Control in the Federal Government (Green Book)

In the 20 years since COSO released its *Internal Control—Integrated Framework* (the original framework), government operating environments have changed dramatically, becoming increasingly complex and technologically driven. At the same time, stakeholders are more engaged, seeking greater transparency and accountability for the integrity of systems of internal control that support government decisions and governance of the entity.

In 2013, COSO published the updated *Internal Control—Integrated Framework* (framework). COSO believes the framework will enable organizations to effectively and efficiently develop and maintain systems of internal control that can enhance the likelihood of achieving the entity's objectives and adapt to changes in the business and operating environments.

In 2014, in conjunction with the requirements of *The Federal Managers' Financial Integrity Act (FMFIA)*, the Comptroller General of the United States issued the Standards for Internal Control in the Federal Government (known as the Green Book). The Green Book addresses not only the five components of internal control, but also adopts the concept of principles, related to the five components of internal control, as introduced by the 2013 COSO framework. The Green Book is not only a federal requirement; it is also considered a best practice for state and local governments.

The 2004 ERM framework and the two aforementioned internal control frameworks are intended to be complementary. Yet, while these frameworks are distinct and provide a different focus, they do overlap. The ERM framework encompasses internal control, with several portions of the text of the original COSO *Internal Control—Integrated Framework* reproduced. Consequently, the ERM framework remains viable and suitable for designing, implementing, conducting, and assessing enterprise risk management.

Both of the aforementioned Internal Control frameworks remain in place as tools for evaluating internal control by itself and are also encompassed within enterprise risk management. The relationship between internal control and enterprise risk management is possibly best captured by the phrase “you can have effective internal control without effective enterprise risk management, but you cannot have effective enterprise risk management without effective internal control.”

Internal control is an integral part of enterprise risk management, which is a broader conceptual tool, expanding and elaborating on internal control, focusing more fully on risk, especially as it relates to strategic considerations.

These key areas are included in the ERM framework to expand on the internal control framework:

- *Objectives*: The internal control framework specifies three categories of objectives—operations, financial reporting, and compliance. The ERM framework adds strategic objectives and expands the reporting objective to cover all reports developed and disseminated internally or externally, and expands the scope to cover non-financial information.

- *Environment*: The ERM framework discusses an entity's risk management philosophy, which is the set of shared beliefs and attitudes characterizing how an entity considers risks, and reflects its culture and operating style.
- *Risk appetite and risk tolerance*: Risk appetite, set by management, with oversight by the governing body, is a broad-based conceptualization of the amount of risk that a government entity is willing to take to achieve its objectives. Often expressed as the desired or acceptable balance among growth, risk and return, or as stakeholder value-added measures, a government entity's risk appetite serves as a guidepost for making strategic choices and resource allocation decisions that are consistent with its established risk appetite.

The risk appetite is supported by more specific risk tolerances that reflect the degree of acceptable variation in performance relative to the achievement of objectives. Risk tolerances are usually best measured in the same units as the objectives that they relate to, and are aligned with the overall risk appetite.

- *Portfolio view of risk*: The ERM framework also introduced the notion of taking a portfolio view of risk—looking at the composite of entity risks from a portfolio perspective. A portfolio view of risk can be depicted in a variety of ways. A portfolio view may be gained from looking at major risks or event categories across business units, or by focusing on risk for the entity as a whole using capital, operating earnings or other metrics. Taking a portfolio view enables management to determine whether it remains within its risk appetite, or whether additional risks should be accepted in some areas in order to enhance returns.
- *Risk assessment and response*: In addition to considering risk from a portfolio perspective, the ERM framework calls attention to interrelated risks, where a single event or decision may create multiple risks.

The framework also identifies four categories of risk response that are taken into consideration by management in looking at inherent risks and achieving a residual risk level that is in line with the entity's risk tolerances and overall risk appetite.

There are four risk response categories:

1. *Acceptance*: No action is taken to affect risk likelihood or impact.
2. *Avoidance*: Exiting the activities giving rise to risk; may involve exiting a program or funding stream, declining expansion of programs with losses, or discontinuing a program or department.
3. *Reduction*: Action is taken to reduce risk likelihood, impact, or both; typically involves many everyday business decisions.
4. *Sharing*: Reducing risk likelihood or impact by transferring or otherwise sharing a portion of the risk; common techniques include purchasing insurance products, forming joint ventures, engaging in hedging transactions, or outsourcing an activity.

Other Key Terms in Enterprise Risk Management

There are several additional terms that you will hear when discussing enterprise risk management. They are described in the rest of this section.

Inherent and residual risk: Management needs to consider both inherent and residual risk. Inherent risk is the risk to the achievement of a government entity's objectives in the absence of any actions management might take to alter either the risk's likelihood or impact. Residual risk is the risk to the achievement of objectives that remains after management's responses have been developed and implemented. Risk analysis is applied first to inherent risk. Once risk responses have been developed, as discussed below, management then considers residual risk. Assessing inherent risk in addition to residual risk can assist the entity in understanding the extent of risk responses needed.

Event identification techniques: A government entity's event identification methodology may comprise a combination of techniques and supporting tools ranging from interactive group workshops and process flow analysis, to technology-based inventories of potential events. These tools and techniques look to past trends, such as loss histories, as well as to the future. Some are industry specific; most are derived from a common approach. They vary widely in levels of sophistication, and most entities use a combination of techniques.

Risk assessment techniques: Risk assessment methodologies comprise a combination of qualitative and quantitative techniques. The use of interviews or group assessment of the likelihood or impact of future events is an example of the application of qualitative risk assessment. Quantitative techniques include probabilistic and non-probabilistic models. Probabilistic models are based on certain assumptions about the likelihood of future events. Non-probabilistic models, such as scenario-planning, sensitivity measures, and stress tests, attempt to estimate the impact of events without quantifying an associated likelihood.

Risk analysis techniques: As part of risk analysis, the government entity analyzes the significance of risks to the achievement of objectives and sub-objectives. Entities may address significance further by using the following criteria:

- *Likelihood and impact of risk occurring:* "Likelihood" and "impact" are commonly used terms, although some entities use instead "probability," "severity," "seriousness," or "consequence." Likelihood represents the possibility that a given event will occur, while impact represents its effect. Sometimes the words take on more specific meaning, with likelihood indicating the possibility that a given risk will occur in qualitative terms such as high, medium, and low. The word probability indicates a quantitative measure such as a percentage, frequency of occurrence, or other numerical metric.
- *Velocity or speed to impact upon occurrence of the risk:* Risk velocity refers to the pace with which the government entity is expected to experience the impact of the risk. For instance a state-owned hospital may be concerned about the potential for a slowdown in the collection of a disproportionate share of hospital receivables when dealing with the changes stemming from the Affordable Care Act. Failing to manage the risks may result in significant erosion in the entity's ability to operate. In this instance, changes in funding

require the need to timely change operations and understand the impact on the need for financing of future operations due to changing cash flow streams.

- *Persistence or duration of time that an occurrence of the risk could affect the entity:* Certain risks are temporary in nature and others are more lasting. For example, the risk of a labor strike that briefly disrupts the ability to provide services has a shorter duration than the risk of a persistent shift in consumer demands for less costly alternatives to healthcare. Additionally, those risks with a potentially high impact that have a low likelihood should be considered, avoiding the notion that such risks “couldn’t happen here,” as even low likelihood risks can occur. The importance of understanding risks assessed as having a low likelihood is greater when the potential impact of the risk might persist over a longer period of time. For instance, the long-term impact on the entity from not providing services for a few days may be viewed much differently than the long-term impact of not being able to compete with lower cost models.

Portfolio View of Residual Risk Example

The following example summarizes ERM concepts.

A government entity providing services to individuals with developmental disabilities held a management team retreat to brainstorm its key risks: changes to programs, changes to the reimbursement system, compliance with rules and regulations for the provision of services, and an increase in the living wage as mandated by the federal government without an increase in funding.

Management assessed the risks and developed risk responses to bring these key risks to within established limits. These responses included establishing a team of inside and outside experts to fully understand the managed care reimbursement and service system, continuous monitoring of compliance with rules and regulations through a quality assurance system, compliance reporting directly to a governing body, and increasing efforts to manage unfunded costs outside of the entity’s control.

Roles and Responsibilities

Everyone in the organization has some role to play in enterprise risk management.

Governing Body: Authority for key decisions involving strategic direction, broad-based resource allocation and setting high-level objectives is reserved for the governing body. Ensuring that objectives are met, determining that resources are utilized effectively, and ascertaining that risks are managed appropriately in the execution of strategy are key functions of the governing body and its committees.

The role of the governing body in providing oversight of enterprise risk management in an organization includes these five responsibilities:

1. Influencing and concurring with the government entity’s risk philosophy and risk appetite
2. Determining that overall strategy and strategic decisions are in alignment with the government entity’s risk appetite and philosophy

3. Ascertaining the extent to which management has established effective enterprise risk management in the government entity
4. Reviewing the government entity's portfolio view of risk and considering it in relation to the entity's risk appetite
5. Being apprised of the most significant risks and ascertaining whether management is responding appropriately

Internal Audit: The role of internal audit in a government entity is largely defined by *Generally Accepted Government Auditing Standards*. The role of internal audit in enterprise risk management could be considered twofold. In addition to identifying and evaluating risk exposures, internal audit activities should include monitoring and evaluating the effectiveness of the organization's risk management system. In this role, internal auditors may support management by providing assurance on the following:

- Enterprise risk management processes, both design and function
- Effectiveness and efficiency of risk responses and related control activities
- Completeness and accuracy of enterprise risk management reporting

The responsibility for evaluating the effectiveness of the government entity's risk management function requires the internal audit function to maintain its independence and objectivity with respect to this function. Accordingly, a best practice from a corporate governance perspective would suggest that reporting responsibility for the risk function be a management responsibility that is separate from internal audit. That said, because of internal audit's position in the government entity and its knowledge of risk assessment, the internal audit team often is responsible for facilitating the ERM process. In the role of facilitator, internal audit can aid in maintaining its independence by communicating its role regularly to stakeholders, including the audit committee. The audit committee should monitor this structure to ensure that roles and responsibilities are understood, and internal audit is maintaining its independence. We do note that if an organization does not have an internal audit function, ERM can still be implemented as it is a very important function within the organization.

Limitations of Enterprise Risk Management

Effective enterprise risk management will provide reasonable assurance about the achievement of an entity's objectives to management and the governing body. However, achievement of objectives is affected by limitations inherent in any management process and the inherent uncertainty of all human endeavors.

The role and reality of human judgment in all aspects of management, including the selection of appropriate objectives, the inevitability of some degree of failure or error, and the possibility of collusion or management override of the process, are limiting factors that decrease the effectiveness of management-level decisions. Another important limitation that must be considered is the cost of various risk response alternatives in relation to their projected benefits.

Conclusion

This primer should have given you a sense of what is meant by enterprise risk management, and an understanding of the responsibilities of the governing body and the audit committee with respect to risk management within an organization.

While some risk management practices and techniques are complex and sophisticated, the overall concept of enterprise risk management is not. Essentially, COSO ERM is a robust comprehensive framework that organizations, their management, and governing bodies can use to manage risks and opportunities effectively in line with strategic choices.

Much of enterprise risk management encompasses governing body and management responsibilities that previously may have been carried out intuitively or in a manner less comprehensive and systematic than is contemplated by an enterprise approach.

All organizations from small governments to large, face myriad risks and opportunities in a rapidly changing world. Whether small or large, local or global, a more explicit, enterprise approach to risk management can help an organization maximize its opportunities while avoiding unnecessary pitfalls or surprises.

Enterprise Risk Management: A Tool for Strategic Oversight

The next chapter in this toolkit, chapter 19, “Enterprise Risk Management: A Tool for Strategic Oversight,” contains a tool with questions modeled on the COSO framework, *Enterprise Risk Management—Integrated Framework*.

Chapter 19: Enterprise Risk Management: A Tool for Strategic Oversight

Overview: The tool in this chapter is created around the eight interrelated components of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Enterprise Risk Management (ERM) Framework.¹ Refer to chapter 18, “Enterprise Risk Management: A Primer on the COSO Framework,” in this toolkit, for a discussion of the components.

When each of the eight components is determined to be effective in each of the four categories of objectives, the governing body and management have reasonable assurance that they understand the extent to which the government entity’s strategic and operations objectives are being achieved and that the government entity’s reporting is reliable and applicable laws and regulations are being complied with.

Instructions for using this tool: Within each section is a series of questions that the audit committee should answer to verify that the components of enterprise risk management are present and functioning properly.

These questions should be discussed in an open forum with executive management and program directors, as well as members of the financial management, risk management, and internal audit teams to ensure that the enterprise risk management function is operating as management represents. Performance audits performed by federal inspectors general, state auditors, local government auditors, and internal auditors contribute to understanding some of the risks associated with the particular government entity.

Evaluation of the risk management process is not a one-time event, but is, rather, a continuous activity for the audit committee, which should always look for potential deficiencies, and should probe the responsible parties continually regarding risks and opportunities.

¹ The questions in this tool are adapted from *COSO Enterprise Risk Management—Integrated Framework* (Product Code Number 990015), published September 2004 by the Committee of Sponsoring Organizations. It may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of this publication are used to support the continuing work of COSO.

COSO Framework	Yes	No	Not sure	Comments
Internal Environment				
1. Is the assignment of risk oversight mandated clearly? Ultimately, the governing body is responsible for overseeing risk management, but oversight of the risk management process is often delegated to an oversight committee such as the audit committee.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Is the government entity’s philosophy for managing risk articulated in a comprehensive code of conduct or in other policies that address acceptable business practices and expected behavior?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is the risk appetite for the government entity articulated formally in qualitative or quantitative terms?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Is the risk appetite consistent with the stated risk management philosophy and aligned with business strategy? Is it included in the strategic plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Are the audit committee’s responsibilities for strategic oversight of risk assessment and risk management defined in its charter or by-laws?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Objective Setting				
1. Has the governing body established high-level objectives that are consistent with the strategic direction and risk appetite for the government entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Has management identified critical success factors, relevant performance measures, milestones, and risk tolerances for the achievement of the government entity’s strategic objectives?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
3. Has management identified breakpoints or risk tolerances that will trigger broad discussion of the potential need for intervention or modification of strategy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Has management established operations, reporting, and compliance objectives that are aligned with the overall strategic objectives?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is a relevant and timely progress reporting mechanism in place to monitor implementation of the strategy?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Event Identification				
1. Has management employed a systematic approach in the identification of potential events that will affect the government entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Is the categorization of events across the government entity, vertically through operating units, by type (including internal, external, and strategic) or by objective appropriate to the entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Has management included high impact, low likelihood events in its portfolio of events for assessment?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Risk Assessment				
1. Has management conducted a systematic assessment of the likelihood, impact, velocity, and persistence of all events with the potential for significant impact on the government entity? The risk events should be assessed individually and not be aggregated into categories for assessment and reporting.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
2. Has management considered sufficiently the interdependency of potentially related events in its event identification and risk assessment process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Risk Response				
1. Has management adopted an appropriate and cost-effective array of risk responses, such as mitigation strategies, at the activity level of the government entity to reduce inherent risks to levels in line with established risk tolerances?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Has management taken a portfolio view to assure that the selected risk responses have reduced the entity's overall residual risk to a level within the identified risk appetite for the government entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Control Activities				
1. Has management implemented adequate control activities throughout the government entity to assure that its risk responses are carried out properly and in a timely manner?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Information and Communication				
1. Do the government entity's management information systems capture and provide reliable, timely, and relevant information sufficient to support effective enterprise risk management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Have adequate communication vehicles been implemented to assure that relevant risk-related information is communicated by front-line employees upward in the government entity and across programs or processes?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
3. Is the portfolio of risks identified in the ERM process included in the strategic planning process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Monitoring				
1. Are sufficient ongoing monitoring activities built into the government entity's operating activities and performed on a real-time basis to allow for appropriate reaction to dynamically changing risk conditions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Has evaluation of the ERM process, either in its entirety, or specific aspects, been given adequate consideration in the scope of internal audit work, if applicable?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Have all deficiencies in risk management processes identified by internal audit, or as a result of ongoing monitoring activities, been communicated to the appropriate levels of management, the governing body, or both?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Do the governing body's agendas promote integration of risk issues with other agenda items such as strategy, organization, and finance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Have all deficiencies and recommendations for improvement in risk management processes been addressed? Have appropriate corrective actions been taken?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. When new policies, programs, and other activities are implemented to enhance the government entity but also subject it to inherent risk, are results monitored to determine whether those new activities create more risk than anticipated?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Chapter 20: Single Audits or OMB A-133 Audits—Audits of Federal Funds

Overview: The Office of Management and Budget (OMB) has issued final guidance, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Grant Guidance [UGG]), that establishes uniform cost principles and audit requirements for federal awards to nonfederal entities and administrative requirements for all federal grants and cooperative agreements. The Uniform Grant Guidance will be effective for nonfederal entities for all federal awards or funding increments provided after December 26, 2014. The standards in the new Audit Requirements of the guidance will be effective for audits of fiscal years beginning on or after December 26, 2014.

The Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (superseded as Subpart F in 2 CFR §200.500.520, UGG in 2014) was issued pursuant to the Single Audit Act of 1984 and the Single Audit Act Amendments of 1996. Subpart F establishes the standards in order to obtain consistency and uniformity among federal agencies for the audit of states, local governments, and not-for-profit entities expending federal awards.

This chapter is intended to aid state and local governments, other government entities, and their audit committees in complying with the requirements and expectations of the Single Audit Act, as well as to assist with compliance of the provisions of the act. The management and audit committee should answer the questions contained in this chapter to verify that the policies and procedures for complying with Federal rules and regulations are present and functioning properly.

The Single Audit Act as amended requires that nonfederal entities (defined as state and local governments and not-for-profit entities) that expend \$750,000 (\$500,000 for years ending prior to 12/26/2014) or more during the entity's fiscal year in federal awards have a single or program-specific audit in accordance with the provisions of the Single Audit Act. The determination of when an award is expended should be based on when the award activity occurs. Expenditures include cash transactions, loans, loan guarantees, federally restricted endowment funds, and various other types of noncash assistance, such as interest subsidies. A program-specific audit may be elected only when an auditee expends federal awards under one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require the auditee to have a financial statement audit.

Requirements and Responsibilities

Audit committees of government entities that are either recipients or sub-recipients of federal awards are required to ensure that the entity maintains a system of internal control over all federal programs in order to demonstrate compliance with pertinent laws and regulations. A

recipient means a non-federal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program. A sub-recipient is an entity that receives a federal award indirectly through a state or local government or a not-for-profit entity. Some of the questions audit committees should understand are as follows:

- Has management identified all federal awards by Catalog of Federal Domestic Assistance (CFDA) number, including clusters of programs, federal program title, federal awarding agency, and any pass-through entities if applicable on a timely basis? Also has management identified the rules and regulations and compliance requirements related to each federal award?
- Does the government entity have a system of internal control over compliance with rules and regulations related to all federal programs and is the system functioning properly?
- Does the system of internal control over compliance provide for timely and effective communication of rules and regulations to program and accounting staff?
- Does the system of internal control over compliance provide for timely monitoring of its effectiveness and compliance with the applicable rules and regulations?
- Does management monitor compliance and take timely action for correcting weaknesses in the design of system of internal control or its implementation?
- Are the audits mandated under the UGG performed and copies provided to the Federal Audit Clearinghouse as required in a timely manner?
- If audit findings and questioned costs are identified, is there a process to address the findings? Does the process involve specific responses and, when necessary, taking corrective action that will resolve current or previous findings, or both?
- Was the reporting package prepared in conjunction with the independent auditor submitted electronically with the data collection form, and electronically signed by both the auditee and the auditor within the required timeline? Note that the recipient entity is legally responsible for the accuracy and timely submission of these forms even if the auditor prepares the forms.
- Has the government entity appropriately monitored any sub-recipients and has the entity obtained a copy of the sub-recipient entity Single Audit audit report? If there were any findings, were they addressed?

Oversight of Independent Auditors and Audited Financial Statements

The audit committee should understand the responsibilities of the auditors of recipients of federal awards and their reporting responsibilities to the not-for-profit entity. These are as follows:

Auditors of recipients of federal awards are required to:

- Plan and conduct the financial statement audit in accordance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS).

- Plan and conduct the audit of compliance for each major federal program in accordance with generally accepted auditing standards (GAAS), generally accepted government auditing standards (GAGAS) and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (UGG after December 26, 2014).
- Determine if the organization-wide and program-specific financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP).
- Determine if Schedule of Expenditures of Federal Awards (SEFA) is presented in accordance with OMB Circular A-133 (UGG after December 26, 2014) and audited in relation to the entity's financial statements as a whole.
- Determine that the independent auditor performed audit procedures that demonstrate an understanding of the recipient's internal controls and sufficient testing in order to support a "low assessed risk" for major programs.
- Determine that the recipient has complied with laws, regulations, and grant agreements in all material respect through adequate audit procedures.
- Follow-up on the status of previous audit findings.

Awarding agencies have the following responsibilities in the audit process:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency should provide information necessary to clearly describe the federal award.
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements.
- Ensure that audits are completed and filed on time.
- Provide technical assistance to auditors and recipients who may have audit questions.
- Issue a management decision on financial and compliance audit findings within six months after an audit report has been submitted, unless exceptions have been granted by OMB.
- Ensure that recipients follow up on audit findings and develop and implement a corrective action plan if necessary.

Reporting

The auditor's reports over the Single Audit may be either combined with the financial statements or issued in a separate report. The auditor's reports will state that the audit was conducted in accordance with GAAS, GAGAS, and the OMB UGG for Federal Awards and include the following:

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- An opinion (or disclaimer of opinion) about whether the financial statements are fairly presented in accordance with U.S. generally accepted accounting principles.
- An in-relation to opinion (or disclaimer of opinion) about whether the supplementary schedule of expenditures of federal awards is fairly presented in relation to the financial statements taken as a whole.
- Report on internal controls over financial reporting and on compliance and other matters based on an audit of the financial statements.
- Report on compliance and internal control over compliance applicable to each major Federal program required by the UGG Schedule of findings and questioned costs, including:
 - A summary of auditors' results
 - Findings related to the financial statements that are required to be reported in accordance with GAGAS
 - Findings and questioned costs for federal awards
 - Corrective action plan related to the current year's findings, if applicable
 - List of major programs using the required risk-based methodology
 - Determination concerning federal programs regarding whether the recipient of the federal award is a "high risk" or "low risk" auditee

Conclusion

The specific requirements and responsibilities of federal agencies and nonfederal recipients are detailed in OMB Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards.¹ Federal agencies are required to apply the provisions of the UGG to all nonfederal entities that receive and expend federal awards either directly from federal awarding agencies or as sub-recipients who receive federal awards from a pass-through entity. The UGG also contains administrative requirements, cost principles and other important information. Additional information is available from the United States Chief Financial Officers Council web-site, www.cfo.gov/cofar.

¹ See www.gpo.gov/fdsys/pkg/FR-2013-12-26/pdf/2013-30465.pdf

Chapter 21: Unique Transactions and Financial Relationships

Overview: Some transactions and financial relationships put a government entity at increased financial risk. Generally accepted accounting principles provide guidance about how a government entity should account for and report these transactions and relationships as a means to fully inform the entity's constituents. It is important that the audit committee understand the nature and the reason for these transactions and relationships, and ensure that management adequately discloses them in the entity's financial statements. This tool is intended to assist audit committee members in gaining an understanding of these unique transactions and relationships so they may assess the appropriateness of management's accounting treatment for them and whether it meets the objectives of financial reporting.

Some transactions and financial arrangements put a government entity at increased financial risk. The audit committee should be aware of these transactions, relationships, and circumstances that may require recognition in the entity's financial statements and should ensure that those transactions and events have been accounted for properly. The following are some of the more common of these transactions and relationships that the audit committee should be aware of:

1. Related party considerations (significant contributions or services provided by or contracts with the governing body).
2. Relationships with legally separate entities.
3. Joint ventures.
4. Tax-exempt financing.
5. Investments in derivative financial instruments.
6. Securities lending transactions.

The following sections provide background about these types of transactions and relationships.

Related Party Considerations (Significant Contributions or Services Provided by or Contracts with Directors)

The audit committee should determine the existence of significant related party relationships and transactions with such parties. Transactions with the governing body of the government entity's governing board may have to be disclosed.

The government entity should have an increased sensitivity when it enters into business relationships with the governing body. It also should have appropriate controls (1) for addressing

potential conflicts of interest that could arise in related-party transactions and (2) for ensuring that such transactions are disclosed to and approved by the audit committee.

Additionally, a government entity should determine if any family members or key employees or officers are employed by the government entity. These relationships should be fully disclosed on an annual basis to the governing body and reported as necessary in either financial or cost reports, as applicable.

Relationship With Legally Separate Entities

Separate entities are created by government entities for a variety of reasons.

Financial reporting standards require an entity to determine when a separate organization should be included as part of the entity's financial reporting organization through consolidation. Although detailed and complex analyses ultimately determine which legally separate entities should be consolidated, organizations are generally included if they are controlled by the entity.

Joint Ventures

A *joint venture* is a legal entity that results from a contractual arrangement to pool resources and share the costs, risks, and rewards of an activity with other organizations. In a joint venture, each of the participants retains an ongoing financial interest, an ongoing financial responsibility, or both.

Joint ventures typically are accounted for using the equity method of accounting. Under the equity method, the entity recognizes its respective share of the joint venture's income or loss and any changes in the value of the joint venture.

Tax Exempt Financing

Many government entities enjoy the benefit of borrowing through the use of tax-exempt bonds. In the typical tax-exempt bond transaction, a government agency issues bonds carrying interest rates below those of taxable bonds. Upon issuance, the bonds are purchased by an underwriter and sold to institutional investors, the general public, or both. Some tax-exempt bonds are issued with credit enhancements, giving the investors in such bonds assurance regarding their credit worthiness. Government entities use credit enhancements to lower the overall cost of borrowing. Bond insurance and letters of credit from highly rated financial institutions are two such enhancements. In such cases, the provider of the credit enhancement usually requires certain fees, financial covenants, collateral, or any combination of such, from the government entity in return for providing the enhancement.

To ensure success, the typical tax-exempt bond transaction involves the services of many experts. For example, the government entity should employ the services of a competent borrower's counsel having an excellent track record in transactions similar to the proposed deal. The government entity will also need a highly experienced underwriter to help structure the deal, guide the process, and eventually sell the bonds. Often, a government entity borrower will engage a financial consultant to assist in developing pro-forma financial statements. If a credit enhancement is part of the plan, the government entity will select an appropriate provider and

negotiate the best possible credit deal. In addition, the issuer and the credit enhancement provider will be represented by legal counsel.

Bond issuance costs generally should not exceed 2 percent of the total face amount issued. Additionally, the repayment term for tax-exempt bonds usually cannot exceed the average estimated economic life of the project costs funded by such bonds and proceeds from the tax-exempt financing generally cannot be used to fund costs for which specific resources have been dedicated, such as restricted contributions received from institutional and individual donors.

Many regulatory issues are operative in issuing tax exempt bonds. The audit committee of a government entity tax-exempt bond issuer should obtain assurance from management, competent advisors, or both that all applicable laws and regulations have been observed. Specific consideration should be given to the following:

- State laws governing the issuance and the use of tax-exempt bond proceeds—Although tax-exempt borrowing is allowed by federal law (under certain circumstances), each state must enact enabling legislation to designate conduit issuers and regulate the use of tax-exempt bond proceeds. For example, some states may restrict the use of tax-exempt bond proceeds to housing programs.
- IRS regulations concerning the following:
 - Use of proceeds—IRS regulations include specific qualified uses for tax-exempt bond proceeds. Generally, proceeds must be used primarily for capital projects, with certain exceptions. No more than 2 percent of proceeds may be used to finance issuance costs.
 - Qualifying borrowers and issuers—Issuance of tax-exempt bonds and use of the proceeds therefrom are restricted to certain types of entities. The IRS is the watchdog agency to ensure that the substantial benefits provided by tax-exempt borrowing accrue only to the intended beneficiaries.
 - Arbitrage rebate—These regulations are complex, usually requiring the assistance of special experts to ensure compliance. IRS arbitrage rebate regulations ensure that a government entity borrowers use bond proceeds in a timely manner in compliance with tax regulations.

If a government entity issuer earns a profit from investment of tax-exempt bond proceeds in taxable securities and fails to timely use this profit (arbitrage) to pay project costs, IRS arbitrage rebate regulations require the government entity to return (or rebate) the excess investment earnings to the U.S. Treasury or face severe penalties.
- SEC regulations concerning public debt offerings—Regulations include compliance requirements regarding initial offering statements, the types and quality of information provided to the public and the veracity of statements made concerning the bonds. Additionally, under SEC Rule 15c2-12, issuers of fixed-rate tax-exempt debt are required to make prescribed secondary market disclosures until the bonds are retired.

In short, due to the complexity of tax-exempt bond transactions, it is imperative that an audit committee monitor the entity's compliance with laws and regulations, both for the initial offering and on an ongoing basis after the debt has been issued. The audit committee should review the details of a proposed tax-exempt bond transaction well before the anticipated issuance date.

Derivatives

An entity's investment policies may allow investments in financial instruments that are not routine or actively traded in the market. Routine or actively traded financial instruments, such as repurchase agreements, government agency debt securities, and money market funds, have some degree of risk. However, derivatives, which are financial instruments or contracts that have unique characteristics underlying their ultimate investment yield, typically have much greater risk.

When a government entity holds derivatives, these financial instruments are included in the amount of investments reported in the entity's financial statements, at the instrument's market value, referred to as its fair value. In many cases the derivative may not be actively traded in the market, or its fair value may be based on complicated, unknown events. For this reason, the notes to the financial statements should include the following: (1) the entity's objectives for holding or issuing derivatives, (2) the context needed to understand those objectives, and (3) its strategies for achieving those objectives. In addition to many other details, the disclosure should provide information about the entity's policies related to the various types of derivative instruments and a description of the items or transactions for which risks are hedged.

Securities Lending Transactions

Sometimes, government entities have large amounts of long-term investments in their portfolios. If an entity wants to earn additional income, it might lend some securities to brokers or financial institutions that need to borrow those securities to cover a short position (that is, they sold a security without owning it) or to avoid a failure to receive a security it purchased for delivery to a buyer. In these transactions, the entity transfers its securities for collateral, which may be cash or other securities, and agrees to return the collateral for its original securities at some time in the future.

When an entity lends its securities, it reports these securities as "pledged assets." In fact, the value of the cash or the securities received as collateral must be reported as assets in the financial statements. Of course, because the collateral must be returned in the future, the entity also reports a liability for these transactions in the financial statements. In addition, the notes to the financial statements should disclose the following:

- The policy for requiring collateral or other security
- The carrying amount and classification of assets not reported separately in the statement of financial position
- The fair value of collateral and the amount sold or re-pledged as of the statement date in situations in which the transferor has received collateral that it is permitted to sell or re-pledge

Audit Committee Questions for Management

Instructions for using this tool: The sample questions included in this tool are a starting point for understanding unique transactions and special relationships that may be present in a government entity. Audit committee members should answer the following questions in discussion with management and consultation with the external auditor or other experts as needed.

Interviewer Notes	
Significant Contracts With Directors	
1. Has the government entity entered into any contracts or agreements with anyone charged with governance for providing goods or services to the entity? If so, please review the details of the arrangement.	
2. For any such agreements, review how the agreement was disclosed to and approved by the governing body.	
3. Was the agreement reviewed in connection with the government entity's conflict of interest policy, if one exists?	
Legally Separate Entities	
1. Has the government entity created, authorized, or become aware of any legally separate organizations that have financial relationships with the government entity? If so, provide details of the arrangement.	
Joint Ventures	
1. Has the government entity entered into any agreement with another organization to share resources, costs, and risks for providing goods and services or other purposes? If so, describe the details of the arrangement.	

Interviewer Notes	
<p>2. For any such agreements, please describe how the government entity accounts for its participation and how the effects of such participation are displayed or disclosed in the entity’s financial statements.</p>	
Tax-Exempt Bond Offerings	
<p>1. Review the proposed tax-exempt bond transaction deal points, including use of funds, bond structure, interest rate mode, credit enhancement, covenants, collateral, repayment terms, and source of repayment funds, for example.</p>	
<p>2. Review the process for selection and qualifications of expert advisers engaged to assist with the tax-exempt bond transaction including the following:</p>	
<ul style="list-style-type: none"> • Borrower’s counsel 	
<ul style="list-style-type: none"> • Financial consultant underwriter 	
<ul style="list-style-type: none"> • Bond counsel 	
<ul style="list-style-type: none"> • Credit enhancement provider 	
<ul style="list-style-type: none"> • Arbitrage rebate compliance consultant 	
<ul style="list-style-type: none"> • Bond trustee 	
<p>3. Review the procedures management will implement to ensure compliance with state and federal laws and IRS and SEC regulations governing tax-exempt bond transactions. Specifically, how will management protect the government entity from the risk of noncompliance default?</p>	

Interviewer Notes	
4. Review management’s proposed accounting treatment of issuance costs and review the tax-exempt bond footnote disclosure in the financial statements.	
5. Review the initial offering statement. Discuss compliance with SEC regulations including Rule 15c2-12 disclosures, if applicable.	
6. Review IRS Form 8038, “Information Return for Tax Exempt Private Activity Bond Issues.” Discuss ongoing compliance with IRS regulations concerning arbitrage rebate rules, if applicable.	
7. Review all debt covenants resulting from the tax-exempt bond transaction and procedures to ensure compliance on an ongoing basis. Review the material debt covenants footnote disclosure in the financial statements.	
Derivatives	
1. Review the government entity’s policies for investing in derivative financial instruments. Are there any restrictions regarding the type, maturity length, or percentage of total portfolio?	
2. Review how management has valued its derivatives for financial statement presentation. Discuss the types of risks these investments have and how management has decided to manage those risks.	
Securities Lending	
1. Review the government entity’s policies for entering into securities lending agreements.	

Interviewer Notes	
<p>2. Review how securities lending transactions have been accounted for and whether they have been included in the government entity’s financial statements. Include whether collateral can be used to purchase securities, whether maturities of original and collateral securities match, and the credit risk associated with the securities.</p>	
Other Questions and Notes:	

Chapter 22: Analytical Procedures and Ratio Analysis for Government Entities

Overview: The ratios presented in this chapter are a guide for organizations to use, and one should understand what they mean for each specific government entity. No two government entities are the same; therefore using a ratio or benchmark that may be significant for one government entity may not have the same significance for a different entity. Users should avoid the tendency to view standalone ratios as either “good” or “bad” based on whether they are high or low or comparing multiple government entities that conduct different activities, have different demographics, or are in different points in their lifespan. With that in mind, the metrics and indicators in this chapter are most helpful if used consistently and compared from period to period within the same entity.

The key financial ratios below are calculated for four major financial statements’ categories: (1) government-wide (governmental activities only), (2) governmental funds, (3) General Fund, and (4) business-type activities.

(1) Government-Wide Governmental Activities

Government-wide financial statements report information on all of the non-fiduciary activity of the government and its component units. The study focuses on governmental activities that are normally supported by taxes and intergovernmental revenues. The government-wide financial statements use the economic measurement flow and accrual basis of accounting. The measurement and timing of recognition is similar to that of a business entity.

Government-wide General Ratios

Change in net position as a percent of net position

Formula:

$$\frac{\text{Increase (decrease) in governmental activities net position}}{\text{Governmental activities net position, beginning of year}}$$

Interpretation: The ratio measures the change in the government entity’s financial condition for the year. A positive ratio indicates that the financial condition has improved; a negative ratio indicates a deteriorating financial condition.

Revenue coverage ratio

Formula:

$$\frac{\text{Governmental activities current year revenue}^*}{\text{Governmental activities current year expense}}$$

* Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures inter-period equity—whether current year revenue covers the cost, including depreciation, of providing current year services. A ratio greater than 1.00 indicates positive inter-period equity; current year taxpayers are providing adequately for current year services. When the ratio falls below 1.00, either prior year revenues were used to fund a portion of current year services or future citizens are being burdened with some of the cost for providing services consumed currently. A higher value for the ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing services commensurate with the current revenues being generated from its tax base.

Unrestricted net position as a percent of current year revenue

Formula:

$$\frac{\text{Governmental activities unrestricted net position}}{\text{Governmental activities current year revenue}^*}$$

* Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures the ability of the government entity to operate if its normal revenue stream is temporarily interrupted or significantly impaired. The ratio is the measure of the cushion that the government entity has for bad years. Municipalities may set a target minimum value for this ratio. A higher ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing appropriate current services for its constituents based on its recurring revenue stream.

Accumulated depreciation as a percent of depreciable capital assets

Formula:

$$\frac{\text{Governmental activities accumulated depreciation, end of year}}{\text{Governmental activities depreciable capital assets, end of year}}$$

Interpretation: The ratio is a measure of the relative age of depreciable capital assets compared to the assets' economic lives. Lower ratios are considered to be more favorable; the government entity will not face significant replacement cost in the near future.

*Government-wide Liquidity Ratio***Liquidity ratio***Formula:*

$$\frac{\text{Governmental activities liquid assets}^*}{\text{Governmental activities current liabilities}}$$

*Cash and short-term investments, excluding any restricted assets

Interpretation: The ratio measures the government entity's ability to meet current obligations from existing cash and short-term investment balances. A higher ratio is considered favorable indicating that the government entity will be able to pay current liabilities as they become due.

*Government-wide Debt Ratios***Debt to assets leverage ratio***Formula:*

$$\frac{\text{Governmental activities total debt}^*}{\text{Governmental activities total assets}}$$

* Total long-term liabilities excluding operating liabilities such as accrued compensated absences, claims and judgments payable, and pension obligations. Short-term operating debt is also not included.

Interpretation: The ratio is a measure of the degree to which the government entity's total assets have been funded with debt. A lower ratio is considered favorable indicating that the government does not have significant creditor claims against its assets and has less risk of default on debt.

Total debt per capita*Formula:*

$$\frac{\text{Governmental activities total debt}^*}{\text{Population}}$$

*Total long-term liabilities excluding operating liabilities such as accrued compensated absences, claims and judgments payable, and pension obligations.

Interpretation: The ratio is a measure of the debt burden to citizens. A lower ratio is considered favorable indicating that the citizens are less heavily burdened. The government entity has the ability to issue future debt at a lower cost.

*Government-wide Revenue Ratios***Tax revenue per capita***Formula:*

$$\frac{\text{Governmental activities tax revenue}}{\text{Population}}$$

Interpretation: The ratio is a measure of the tax burden to citizens. A lower ratio is considered favorable indicating that current citizens are paying lower taxes. Therefore the government entity has greater ability to increase taxes to meet future needs.

Total grants, contributions and other intergovernmental revenue as a percent of total revenue

Formula:

$$\frac{\text{Governmental activities total operating grants and contributions} + \text{total capital grants and contributions} + \text{other intergovernmental revenue}}{\text{Governmental activities total revenue}^*}$$

*Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures the government entity's reliance on grants, contributions and other intergovernmental revenue. A lower ratio is considered favorable indicating that the government entity is less reliant on external sources that are beyond its control.

Government-wide Expense Ratios

Expense ratios measure the current-period cost of providing services to citizens or current-period financing cost. Functional expense categories include depreciation measuring the cost of using capital assets to provide current year services. Low ratios are depicted as favorable. However, the amount of expense incurred is not necessarily commensurate with the quality, efficiency or effectiveness of the service provided.

Total expense per capita

Formula:

$$\frac{\text{Government- wide total expense}}{\text{Population}}$$

Interpretation: The ratio is a measure of the expense necessary, on average, to provide services to a given citizen. A lower ratio is considered favorable indicating that a government entity is providing services to citizens at a comparatively lower cost. However, when comparing the results of this ratio between two different municipalities, one must consider whether the two municipalities provide comparable levels of police, fire, waste management, parks and recreation, and similar services. In addition, the amount of expense incurred is not necessarily commensurate with the quality, efficiency or effectiveness of the services provided.

Total general government (administration) expense per capita

Formula:

$$\frac{\text{Government- wide general government (administration) expense}}{\text{Population}}$$

Interpretation: See previous interpretation of total expense per capita.

Total public safety expense per capita*Formula:*

$$\frac{\text{Government-wide public safety expense}}{\text{Population}}$$

Interpretation: See previous interpretation of total expense per capita.**Total interest expense per capita***Formula:*

$$\frac{\text{Government-wide interest expense}}{\text{Population}}$$

Interpretation: The ratio is a measure of the interest expense incurred per citizen. A lower ratio is considered favorable, indicating that a government entity has minimized its debt obligations, and reduced the strain that debt service payments can place on current municipal resources.**(2) Governmental Funds**

Governmental funds are used to account for the basic activities of the government entity that are not supported by user charges or characterized by the government entity acting in a fiduciary capacity. Governmental funds account for operations, acquisition of capital assets related to basic operations, and the debt service requirements for related debt. Primary resources are taxes, intergovernmental revenues and, for capital asset acquisition, long-term debt proceeds. Governmental funds report using the current financial resource measurement flow and the modified accrual basis of accounting. Expenditures are often controlled by annual budgets.

Total debt service expenditures as a percent of total revenues*Formula:*

$$\frac{\text{Governmental fund debt service expenditures}}{\text{Governmental fund total revenues}}$$

Interpretation: This ratio measures the amount of current revenue that is devoted to meeting the year's debt service requirements. Significant debt service requirements potentially lower the amount that can be used for providing current services. A low ratio is considered favorable.**Capital outlay expenditures as a percent of total expenditures***Formula:*

$$\frac{\text{Governmental fund capital outlay expenditures}}{\text{Governmental fund total expenditures}}$$

Interpretation: The ratio measures whether the government entity is adequately providing for capital asset additions and improvements. A high ratio is considered favorable indicating that the government entity is providing adequately for its capital asset needs.

(3) General Fund

The General Fund is the primary operating fund of a government entity. It accounts for the revenues that are not restricted for specific purposes and activities. Most of the basic operations of the government entity are accounted for in the General Fund. The General Fund, a governmental fund, reports using the current financial resource measurement focus and the modified accrual basis of accounting.

Unrestricted fund balance as a percent of total revenues

Formula:

$$\frac{\text{General Fund unrestricted fund balance}^*}{\text{General Fund revenues}}$$

*Includes both assigned and unassigned fund balance.

Interpretation: The ratio measures the ability of the General Fund to continue operations if its revenue is temporarily interrupted or declines. This is a measure of the General Fund operating cushion. Municipalities may set a target for this ratio. A higher ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing the level of services commensurate with its revenue stream.

Intergovernmental revenue as a percent of total revenue

Formula:

$$\frac{\text{Governmental fund intergovernmental revenue}}{\text{Governmental fund total revenue}}$$

Interpretation: The ratio measures the General Fund's reliance on revenues from external sources to finance current operations. A low ratio is considered favorable indicating that the General Fund is not overly reliant on revenue sources that are beyond its control.

Transfers in as a percent of total revenues and transfers in

Formula:

$$\frac{\text{General Fund transfer in}}{\text{General Fund total revenues and transfers in}}$$

Interpretation: The ratio measures the reliance of the General Fund on transfers from other funds. To the extent the transfers are from enterprise funds, the users of enterprise services may be subsidizing General Fund operations. A low ratio is considered favorable indicating that the General Fund is not dependent on transfers.

(4) Business-Type Activities

Business-type activities within a government entity are operations that financed and operated in a manner similar to a private business entity. This can include airports, public utilities, hospitals, and colleges. The revenues collected are intended to operate and provide the function or services that the customer expects. The ratios used may vary based on the entity's industry.

Debt Service Coverage

Formula:

$$\frac{\text{Operating Income} + \text{Depreciation} + \text{Interest Income}}{\text{Debt Service Payments (Principal} + \text{Interest)}}$$

Interpretation: The ratio measures the ability of the entity to meet current debt service requirements. Municipalities may set a target for this ratio. A higher ratio is considered favorable. Ratio can be used to project future debt capacity.

Days Cash on Hand (Measure of Working Capital)

Formula:

$$\frac{\text{Cash} + \text{Cash Equivalents}}{(\text{Operating Expenses} - \text{Depreciation})/365}$$

Interpretation: The ratio measures the working capital levels, in relation to the governmental entity's operating expenses. A higher ratio may signal greater financial flexibility. A target is often set for this ratio. This target should be set based on historical cash flow and current entity risks.

Chapter 23: Resources for Audit Committees

Overview: There is a wealth of resources available online to assist audit committee members in discharging their responsibilities. This chapter provides a list of organizations and websites that contain resources for audit committee members to investigate.

Below is a sampling of organizations and websites that can assist audit committee members in learning more about their roles, responsibilities, and functions.

American Institute of Certified Public Accountants

www.aicpa.org

The American Institute of Certified Public Accountants (AICPA) is the national professional association for all certified public accountants. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (including CFOs, controllers, and internal auditors), government, not-for-profit entities, and the academic community.

The AICPA has developed this Audit Committee Toolkit to aid audit committee members in performing their functions. In addition, the AICPA produces publications on accounting and auditing, financial reporting, tax, technology, and many other relevant topics. Some additional online resources useful to audit committees include the following:

- Audit Committee Effectiveness Center and Matching System at www.aicpa.org/audcommctr
- Fraud Resource Center at www.aicpa.org/interestareas/forensicandvaluation/resources/fraudpreventiondetectionresponse/pages/fraud-prevention-detection-response.aspx
- Internal Control Interest Area at www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/CorporateGovernanceRiskManagementInternalControl/Pages/COSO_Integrated_Framework_Project.aspx
- AICPA Governmental Audit Quality Center information at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx
- Forensic and Valuation Services at <http://www.aicpa.org/InterestAreas/ForensicAndValuation/Pages/ForensicValuationHome.aspx>

In addition, the AICPA provides numerous conferences and CPE sessions dedicated to the government sector, the largest of which is the governmental conference held in August of each year.

Association of Audit Committee Members

www.aacmi.org

The Association of Audit Committee Members is a not-for-profit association of audit committee members dedicated to strengthening the audit committee by developing national best practices, including a robust whistleblower system. They are devoted exclusively to improving audit committee oversight.

Association of Certified Fraud Examiners

www.acfe.com

The Association of Certified Fraud Examiners (ACFE) is a global professional organization dedicated to fighting fraud and white-collar crime. With chapters around the globe, the ACFE is networked to respond to the needs of antifraud professionals everywhere. It offers guidance on fraud prevention, detection, and investigation, as well as internal controls. The ACFE publishes the *Report to the Nations on Occupational Fraud and Abuse* body of research aimed at deepening knowledge and understanding of the tremendous financial impact of occupational fraud and abuse on businesses and organizations.

Association of Governing Boards of Colleges and Universities

www.agb.org

The Association of Governing Boards of Universities and Colleges is a national organization providing university and college presidents, board chairs, and individual trustees of both public and private institutions with the resources they need to enhance their effectiveness.

Association of Government Accountants

www.agacgfm.org

The Association of Government Accountants (AGA) is an educational organization dedicated to enhancing public financial management. The AGA serves the professional interests of financial managers, from local, state, and federal governments to public accounting firms responsible for effectively using billions of dollars and other monetary resources every day. The AGA conducts independent research and analysis on all aspects of government financial management for the purpose of advocating improvement in the quality and effectiveness of government fiscal administration.

Association of International Certified Professional Accountants

www.cgma.org

The Association of International Certified Professional Accountants established the Chartered Global Management Accountant (CGMA) designation in January 2012. The CGMA's mission is to promote the science of management accounting on the global stage. The designation champions management accountants and the value they add to organizations. Relevant tools and resources supporting board and audit committee responsibilities are included within the vast library on their website.

Association of Local Government Auditors

algaonline.org

ALGA is a professional organization committed to supporting and improving local government auditing through advocacy, collaboration, education, and training, while upholding and promoting the highest standards of professional ethics. The ALGA provides information, guidance, and opportunities for local government auditors about audit standards, related training, peer reviews, and other audit issues.

Business Roundtable

www.businessroundtable.org

The Business Roundtable (BRT) is an association of chief executive officers of leading U.S. corporations. The BRT is committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness. The BRT's Corporate Governance Committee focuses on issues related to corporate governance and responsibilities, including accounting standards.

Center for Audit Quality

www.thecaq.org

The Center for Audit Quality (CAQ) is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a board that comprises leaders from public company auditing firms, the AICPA, and three members from outside the public company auditing profession. The CAQ is dedicated to enhancing investor confidence and public trust in the global capital markets. The "Audit Committee Annual Evaluation of the External Auditor" resource is designed to allow audit committees to evaluate the auditor's performance objectively.

Committee of Sponsoring Organizations of the Treadway Commission

www.coso.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO has released numerous influential publications, including, in May 2013, *Internal Control—Integrated Framework* and the *Enterprise Risk Management—Integrated Framework*.

Conference Board

www.conference-board.com

The Conference Board is a global, independent membership organization that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. The Conference Board conducts research, convene conferences, make forecasts, assess trends, publish information and analysis, and bring executives together to learn from one another. The Conference Board's Commission on Public Trust and Private Enterprise has proposed reforms to strengthen corporate compensation practices and help restore trust in America's corporations and capital markets.

Corporate Board Member

www.boardmember.com

Corporate Board Member magazine's website, Boardmember.com, serves as a central resource for officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. Their resource center offers the full texts of *Corporate Board Member* magazine articles, as well as additional articles, tools, Webcasts, and interviews. Topics include corporate governance, strategic board trends and issues, executive and director compensation, audit committees, risk management, international and technology trends, investor relations, board education, and other critical topics facing today's directors and officers of publicly traded companies. The *Corporate Board Member* extends its governance leadership through an online resource center, conferences, roundtables, and timely research.

Ethics & Compliance Officers Association

www.theecoa.org

The Ethics & Compliance Officers Association (ECO) is the professional association exclusively for individuals responsible for their organizations' ethics, compliance, and business conduct programs. The ECOA provides ethics officers with training and a variety of conferences and meetings for exchanging best practices in a frank, candid manner.

Ethics Resources Center

www.ethics.org

The Ethics Resources Center (ERC) is a nonprofit, nonpartisan research organization, dedicated to independent research that advances high ethical standards and practices in public and private institutions, including a focus on ethics and compliance aspects of the federal government. Their mission is to promote ethical leadership worldwide by providing leading-edge expertise and services through research, education, and partnerships on current and emerging issues. The ERC's resources on business and organizational ethics are especially useful.

Federal Accounting Standards Advisory Board

www.fasab.org

The FASAB serves the public interest by improving federal financial reporting through issuing federal financial accounting standards and providing guidance after considering the needs of external and internal users of federal financial information.

Financial Executives International

www.financialexecutives.org

Financial Executives International (FEI) is a professional association for senior level financial executives, including chief financial officers, vice-presidents of finance, controllers, treasurers, and tax executives. The FEI provides peer networking opportunities, emerging issues alerts, personal and professional development, and advocacy services.

GMI Ratings

www3.gmiratings.com

GMI Ratings was formed in 2010 through the merger of three independent companies: The Corporate Library, GovernanceMetrics International, and Audit Integrity. Drawing on the shared vision and intellectual capital of its predecessor firms, GMI Ratings emerged as a clear leader in the understanding of risks affecting the performance of public companies worldwide. Today, GMI Ratings provides institutional investors, insurers, and corporate decision-makers the most extensive coverage of environmental, social, governance, and accounting-related risks.

Government Finance Officers Association

www.gfoa.org

The Government Finance Officers Association (GFOA), represents public finance officials throughout the United States and Canada. The association's nearly 18,000 members are federal, state/provincial, and local finance officials deeply involved in planning, financing, and implementing of thousands of governmental operations in each of their jurisdictions. The GFOA's mission is to enhance and promote the professional management of governmental financial resources by identifying, developing, and advancing fiscal strategies, policies, and practices for the public benefit.

Governmental Accounting Standards Board

www.gasb.org

The Governmental Accounting Standards Board (GASB) is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 by agreement of the Financial Accounting Foundation (FAF) and 10 national associations of state and local government officials, the GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments.

Harvard Business School's Corporate Governance

www.exed.hbs.edu

Harvard Business School's Corporate Governance website is a comprehensive overview of research, educational programs, and other activities at Harvard Business School aimed at providing new frameworks for thought and practice in the interrelated areas of corporate governance, leadership, and values. It includes links to the ongoing workshop series, background papers, research programs, executive education programs, viewpoints on key issues published in the national press, faculty comments in the media, and an online forum for exchanging views on emerging issues.

Institute of Internal Auditors

www.theiia.org

The Institute of Internal Auditors (IIA) is an international professional organization that meets the needs of a worldwide body of internal auditors. IIA focuses on issues and advocacy in internal auditing, governance and internal control, IT audit, education, and security worldwide. The Institute provides internal audit practitioners, executive management, boards of directors,

and audit committees with standards, guidance, best practices, training, tools, certification, executive development, research, and technological guidance for the profession.

IT Governance Institute

www.itgi.org

Established by the Information Systems Audit and Control Association and Foundation (ISACA) in 1998, the IT Governance Institute (ITGI) exists to assist enterprise leaders in understanding and guiding the role of IT in their organizations. ITGI helps senior executives to ensure that IT goals align with those of the business, deliver value, and perform efficiently while IT resources are allocated properly to support business goals, optimize business investment in IT, and manage IT-related risk and opportunities appropriately through original research, symposia, and electronic resources. ITGI helps ensure that boards and executive management have the tools and information they need to manage the IT function effectively.

National Association of College and University Business Officers

www.nacubo.org

The National Association of College and University Business Officers (NACUBO) represents chief administrative and financial officers through a collaboration of knowledge and professional development, advocacy, and community. Its vision is to define excellence in higher education business and financial management.

National Association of Corporate Directors

www.nacdonline.org

Founded in 1977, the National Association of Corporate Directors (NACD) is the premier educational, publishing, and consulting organization in board leadership, and the only membership association for boards, directors, director-candidates, and board advisers. The NACD promotes and advances exemplary board leadership through high professional board standards; creates forums for peer interaction; enhances director effectiveness; asserts the policy interests of directors; conducts research; and educates boards and directors concerning traditional and cutting-edge issues.

National Association of State Auditors, Comptrollers, and Treasurers

www.nasact.org

The National Association of State Auditors, Comptrollers and Treasurers (NASACT) is an organization for state officials who work in the financial management of state government. NASACT assists state leaders to enhance and promote effective and efficient management of government resources. NASACT's website provides information regarding, among other things, efforts to improve financial management practices at all levels of government, shares expertise and ideas that promote effective financial management, and develops and promotes an exchange of industry best practices.

Office of Management and Budget

www.whitehouse.gov/omb

The Office of Management and Budget (OMB) publishes the circulars that include federal regulations related to audits of government and not-for-profit entities that receive and expend federal funds.

The Society of Corporate Secretaries & Governance Professionals

www.ascs.org

Originally founded as the American Society of Corporate Secretaries (ASCS), the Society of Corporate Secretaries & Governance Professionals (the society) acts as a positive force for enlightened corporate governance. The Society's key mission is to promote excellence in corporate governance. The Society's members address issues of public disclosure under the securities laws and matters affecting corporate governance, including the structure and meetings of boards of directors and their committees, as well as the proxy process and the annual meeting of shareholders and shareholder relations, particularly with large institutional owners.

U.S. Government Accountability Office

www.gao.gov

The U.S. Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. With its core values of accountability, integrity, and reliability, ultimately, the GAO works to ensure that government is accountable to the American people. The GAO issues *Government Auditing Standards* (also known as the Yellow Book), which contains standards for audits of government organizations, programs, activities, and functions. These standards, often referred to as generally accepted government auditing standards, are to be followed by public accounting firms and audit organizations that audit governments and not-for-profit entities when required by law, regulation, agreement, contract, or policy.

Chapter 24: Glossary of Acronyms

ACFE	Association of Certified Fraud Examiners
AICPA	American Institute of Certified Public Accountants
CAE	Chief Audit Executive (leader of internal audit team)
CAFR	Comprehensive Annual Financial Report
CAQ	The Center for Audit Quality
CAS	Cost Accounting Standards
CEO	Chief Executive Officer
CFDA	Catalog of Federal Domestic Assistance
CFO	Chief Financial Officer
CFR	Code of Federal Regulations
CIO	Chief Information Officer
COFAR	Council on Financial Assistance Reform
COSO	Committee of Sponsoring Organizations of the Treadway Commission
D&B	Dun and Bradstreet
DUNS	Data Universal Numbering System
ERM	Enterprise Risk Management
FAC	Federal Audit Clearinghouse
FAIN	Federal Award Identification Number
FAR	Federal Acquisition Regulation
FASAB	Federal Accounting Standards Advisory Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards (also known as the Yellow Book)
GAO	U.S. Government Accountability Office
GAQC	AICPA's Governmental Audit Quality Center
GASB	Governmental Accounting Standards Board

The AICPA Audit Committee Toolkit: Government Entities

GFOA	Government Finance Officers Association
IA	Internal Audit
IBNR	Incurred, But Not Reported
IC	Internal Control
IDES	FAC's Internet Data Entry System
IIA	Institute of Internal Auditors
IPPF	<i>International Professional Practices Framework</i> (also known as the Red Book)
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IT	Information Technology
MD&A	Management's Discussion & Analysis
OCBOA	Other Comprehensive Basis of Accounting
OMB	U.S. Office of Management and Budget
PCAOB	Public Company Accounting Oversight Board
RFP	Request for Proposal
SAS	AICPA's Statements on Auditing Standards
SEC	U.S. Securities and Exchange Commission
SQCS	AICPA's Statement on Quality Control Standards
SSAE	AICPA's Statements on Standards for Attestation Engagements
TPA	Third-party Administrator
UG	Uniform Guidance (2 CFR Chapters I and Chapter II: Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards)

The Audit Function at Inland Empire Utilities Agency



Background

- Formation of Internal Audit Department & Audit Committee
- Guidance over audit activities
 - GFOA: Government Finance Officers Association
 - IIA: Institute of Internal Auditors
 - AICPA: American Institute of Certified Public Accountants

Survey Agencies

	<i>Inland Empire Utilities Agency (IEUA)</i>	Metropolitan Water District of Southern California (MET)	Sanitation Districts of Los Angeles County (LACSD)	Los Angeles Department of Water and Power (LADWP)	Orange County Sanitation District (OCSD)	East Bay Municipal Utility District (EBMUD)
Department Size	3	11	2 positions 1 currently filled	18	Contracted to outside auditor	3 Total positions (2 filled currently)
Reporting Structure	<i>Reports to the Board through the Audit Committee</i>	Reports to the Board of Directors and the Audit and Ethics Committee	Reports to Chief Accountant, who reports to Department Engineer, reporting to the General Manager	Reports to the Audit Committee	OCSD contracts with External Audit Firm for Internal Audit services	Reports to the Finance Director, who reports to the Finance Committee & Board.
Audit Committee	Yes, <i>Audit Committee</i>	Yes, Audit and Ethics Special Committee	Yes, Audit Committee of Internal Management	Yes, Audit Committee	Yes, Audit Committee	Yes, Finance & Administration committee
Number and Frequency of Audit Committee Meetings	<i>Quarterly</i>	Quarterly or more often	1 meeting per year	Written reports monthly and an annual committee meeting.	every other month	Annual & Semi-annual to the Board
Types of Audits performed	<i>Operational Audits which encompass: Compliance, Financial, etc, Follow-Ups, and Special Projects</i>	Operational, Compliance, Construction Contracts, Consulting Agreements, and special Turf Rebates	Operational	Mandatory audits of joint projects (primarily power transmission), operational audits, IT audits, management requests, billings, write-offs, review concerning lawsuits.	Based on a risk assessment, request "agreed upon procedures." Areas reviewed include fictitious vendors, contracts, separation of duties, etc.	Operational, Compliance, Financial, Vendor leases, Water consumption review, rebate program, lab audit, agreements, etc.
Fraud Hotline	Yes, <i>Third-party EthicsPoint Monitored by Legal Counsel.</i>	Yes, monitored by Ethics Department	Yes, monitored by Internal Auditor	Yes, monitored by the elected office of the Controller managed by the City's audit section.	None	None

Survey Cities

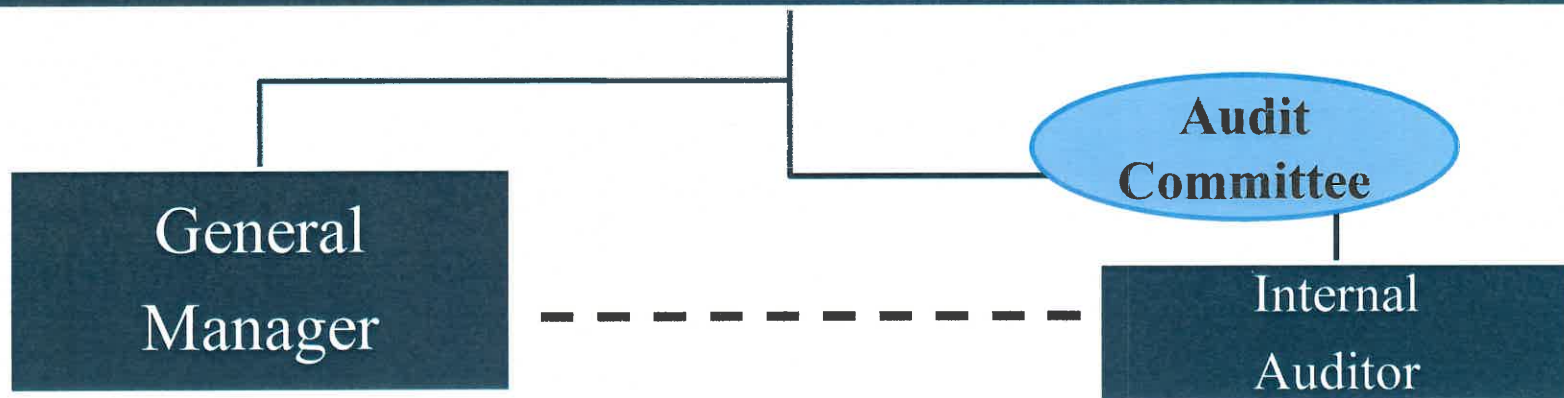
	City of Anaheim	City of Long Beach	City of Ontario	City of Pasadena	City of San Diego	City of Thousand Oaks
Department Size	6	13 auditors Total staff 22	1	2	22	1
Reporting Structure	Internal Audit Division reports to the City Manager's Office	The City Auditor is elected as outlined in City Charter	Internal Auditor reports to the Administrative Officer, who reports to the Management Services Director who reports to the Administrative Services/Finance Director, who reports to the City Manager.	Internal Audit reports to the City Manager	City Auditor reports to the City Council's Audit Committee; City Auditor appointed by City Council for a 10-year term.	Internal Auditor reports to the Finance Director, who reports to the City Manager.
Audit Committee	Yes	No	No	Reports to Finance Committee	Yes. Consisting of 2 City Council members and 2 independent members	Yes, Consists of 2 City Council members
Number and Frequency of Audit Committee Meetings	2 times per year	As needed meetings with the Mayor. Monthly meetings with the City Manager	N/A	Four times per year	Approximately 10 meetings a year	Meets Audit Committee 2 times per year.
Types of Audits performed	Contract Compliance, Operational, Performance, Transient Occupancy Tax, and Public Utilities	Performance audits, investigations and follow ups	Financial, operational, & occasional fraud investigations. Compliance audits for other agencies per grant requirements	Internal Audit performs all types of audits, except for the financial audit	Performance and IT audits	Operational, Compliance, Performance, Financial, Investigations, Follow-ups
Fraud Hotline	No, In the process of establishing a hotline	Yes, Hire an outside agency to take the reports	Yes, monitored by an independent organization.	Yes, Monitored by Internal Audit	Yes, Monitored by Internal Audit	Yes, Monitored by Internal Auditor, third party vendor takes information

Survey Counties

	County of Los Angeles	County of Riverside	County of San Bernardino	County of San Diego
Department Size	130 Total (50 Audit, 50 Contract Monitoring, and 30 Office of County Investigations)	8 (1 Chief, 1 Audit Manager, and 6 Senior Internal Auditors)	14	15 (1 Chief, 2 Managers, 1 Assistant, and 11 auditors)
Reporting Structure	Auditor-Controller	Auditor-Controller	Auditor-Controller/ Treasurer/Tax Collector. Auditor-Controller is an elected position	Auditor-Controller & Audit Committee
Audit Committee	Yes	No	Yes	Yes
Number and Frequency of Audit Committee Meetings	Monthly and Special Audit committee meetings as required	N/A	Quarterly	Quarterly
Types of Audits performed	Department Audits, Management audits, Internal Controls, Special Projects & Investigations	Operational, Compliance, Financial, Investigations	Operational and compliance	Operational, Compliance, Performance, IT, Investigations and Advisory Services
Fraud Hotline	Yes, Fraud Hotline administered by the Office of County Investigations under Auditor-Controller	Yes, Internal Audit Division of the Auditor-Controller's Office monitors the hotline. County uses a third-party.	Yes, Internal Audits administers the Auditor-Controller's Fraud, Waste, and Abuse hotline. Utilizes 3rd party. Report to IA which follows up with related departments.	Yes, IA administers the Fraud hotline. Utilizes 3rd party. IA coordinates with other departments and the Ethics & Compliance Office.

The Audit Function

Board of Directors



Audit Universe
Departments
Processes
Policies
Internal Controls

The Audit Function & Audit Committee Resources



Auditor Contract Fees

YEAR	2013	2014	2015	2016
External Advisor	\$6,190	\$6,190	\$6,190	\$6,190
External Audit	\$37,705	\$38,551	\$39,418	\$41,170
TOTAL	\$43,895	\$44,741	\$45,608	\$47,360

Charter Requirements



The Role of the Internal Audit Department

- Eyes and ears of the Board
- Objective and independent evaluations and reviews
- Assist the Agency in achieving its goals
- Assess internal controls
- Provide assurance on processes and procedures
- Promote strong ethical culture
- On-going monitoring and compliance
- Assist in safeguarding assets
- Raise any potential red flags
- Make recommendations to improve operations
- Communicate results & provide Audit Reports

Types of Audits Performed by Internal Audit



Annual Audit Plan

- FY 2016/17 Annual Audit Plan:
 - Master Service Contracts Audits
 - Information Technology Equipment Follow-Review
 - Water Conservation Programs Audit
 - Wire Transfers and Electronic Disbursements

Annual Audit Plan

- Long Range Audit Planning – Additional Audit Areas
 - Payroll & Time System
 - Accounts Payable – Review of Credit Cards & P-cards
 - Construction Contracts – award through final payment
 - Recycled Water Program
 - Accounts Payable - Duplicate Payments/Late Payments
 - Inter-Fund Transfers and Reserve Requirements
 - Capital Projects
 - Asset Management
 - Operations

Internal Audit Department Responsibilities

- Operational Audits
- Make recommendations to improve operations
- Follow-ups Reviews
- Agency Policy reviews
- Special Requests
- Quality Control Review of CAFR, Disclosures and GFOA recommendations
- Ethics Point
- Annual Audit Plan
- RFP for External Financial Audit Services
- Charters & Standard Operating Procedures
- Continuous Professional Development
- IAD Website on AIM

Audit Committee Meetings

- Audit Reports
 - Scope
 - Observations & Recommendations
 - Auditee Response & Discussion
 - Direction to Proceed
- Required and/or Routine Audit Items
- Administrative Items



Provide direction for Audit Responsibilities and future Audit Committee Meetings

This workshop is consistent with the Agency's Business Goals of Fiscal Responsibility, Workplace Environment and Business Practices by describing the functions, roles and responsibilities of the Internal Audit Department and providing an overview of the components which make up the Audit Function.

Audit Committee

INFORMATION
ITEM
2B



Date: March 15, 2017

To: The Honorable Board of Directors

Through: Audit Committee (3/6/2017)

From: Teresa V. Velarde
Manager of Internal Audit

Subject: Report of Open Audit Recommendations

RECOMMENDATION

The attached is an informational item for the Board of Directors.

BACKGROUND

The Internal Audit Department Charter and professional standards require the Internal Audit Department (IA) staff to follow-up on the status of open audit recommendations to determine if corrective action efforts have been made. The Charter also requires IA to annually provide, to the Audit Committee and the Board, a report listing all outstanding recommendations with action plans and expected resolution dates.

As of the date of this report, there are a total of 88 open/outstanding recommendations. Of the 88 outstanding recommendations, 48 do not require a follow-up review during this year. Seventeen recommendations relate to audits completed recently and 31 relate to the Regional Contract Review where the plan is to address those recommendations through the renegotiation of the Regional Contract. Therefore, 40 recommendations require follow-up, some of the recommendations have been outstanding since August 2010. IA plans to follow-up on 13 recommendations by June 2017, leaving 27 recommendations for follow-up during FY 2018.

Audit guidelines state that an adequate amount of time be granted to provide the auditees with sufficient time to fully implement corrective action plans. IA will continue to evaluate the status of the open recommendations until full implementation has been achieved, the deficiency originally identified is no longer applicable, or alternate internal controls have been accomplished. At the time of the original reviews, follow-up activities are discussed with the responsible business units. Follow-up audit work may include a desk review of supporting documentation, discussions with the auditee, and/or the application of testing procedures to verify implementation. The audited units can, at any time, provide information for IAs verification. Once IA completes a follow-up review, a separate report documenting the status will be reported through the Audit Committee.

Follow-up reviews will be scheduled according to the proposed Annual Audit Plan or sooner if requested by Management, the Audit Committee or the Board. Following is a list summarizing the outstanding recommendations, noting the audited area and the date the original audit report was completed. Attached is a detailed report showing the actual recommendations and the current status of each one.

Report of Open Audit Recommendations

March 15, 2017

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Outstanding Recommendations			
Area Audited	Report Issued Date	No. of Recs. Remaining to be Verified by IA	Planned Follow-Up
Payroll Audit	August 24, 2010	1	Annually
Intercompany Receivables - Watermaster	August 30, 2011	1	FY2017
Human Resources Follow-Up	June 20, 2012	1	FY2017
Contracts and Procurement Follow-Up	August 29, 2012	2	FY2017
2013 Petty Cash	May 31, 2013	5	FY2017
SCE Utility Payments	August 28, 2013	3	FY2017
Accounts Payable Follow-Up	August 29, 2013	9	FY2018
Automobile Insurance Requirements	March 3, 2014	2	FY2018
Vehicle Security Procedures	March 3, 2014	3	FY2018
Vehicle Inventory Procedures	March 12, 2014	13	FY2018
Total Outstanding Recommendations		40	
Recommendations related to the Regional Contract Review			
Regional Contract Review – Final Audit Report	December 16, 2015	31	Pending – Renegotiation of the Regional Contract
New Audit Recommendations Issued in FY 2016/2017			
Follow-Up – Information Technology Equipment Audit – Information Services	February 29, 2016	2	FY 2019
Master Trade Contracts	September 1, 2016	6	FY 2019
Audit of Master Service Contracts	December 14, 2016	3	FY 2019
Follow-Up – Information Technology Equipment Audit – Finance & Accounting	December 5, 2016	6	FY 2019
Total New Recommendations for 2016		17	
Total Recommendations Outstanding		88	

All audit reports referenced here have been submitted through the Board. The Internal Audit website accessible through the Agency’s Intranet and available to all Agency employees, provides all the audit reports issued by the Internal Audit Department.

PRIOR BOARD ACTION

On June 15, 2016, the Board of Directors approved the Annual Audit Plan for Fiscal Year 2016/17. Follow-up activities were scheduled in the plan.

On December 16, 2015, the Board of Directors reconfirmed the amended Audit Committee and Internal Audit Charters.

IMPACT ON BUDGET

None

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Payroll Audit August 24, 2010	4	HR and FMD should work together to revise and update the Agency's Resolution No. 2005-2-9 and clarify which employees are required to sign a Confidentiality Agreement, based on their job duties and responsibilities, specifically those whose roles involve handling sensitive and confidential information. Having employees sign a Confidentiality Agreement reinforces that confidential and sensitive information is being handled, the Confidentiality Agreement also provides the expectations and consequences for sharing or misusing confidential information.	The Executive Management Team and HR continue to work closely with legal counsel to determine the need for updates to the Resolution. IA will continue to follow-up on this item.
Intercompany Receivables - Watermaster August 30, 2011	1	Fiscal Management Department should establish procedures to prepare and submit invoices to Watermaster prior to the beginning of the quarter to allow payment by Watermaster before the quarter begins.	Finance and Accounting stated they will implement the billing requirement to bill in advance of each quarter as required by the contract. IA will verify that this process has been implemented during follow-up evaluation planned for 2017.
Human Resources Follow-Up June 20, 2012	1	Document standard operating procedures to address the many administrative practices of the department.	HR stated they will document and adopt written procedures. HR has updated 10 Standard Operating Procedures (SOPs), which are currently in Draft form. HR is evaluating the need for additional SOPs and finalizing the required SOPs. IA will verify during follow-up evaluation planned by the end of FY 2017.
Contracts and Procurement Follow-Up August 29, 2012	1	The Contracts and Procurement Department should ensure adequate separation of duties exist in procurement transactions. Specifically the functions of creating and approving the Purchase Request, creating the Purchase Order and having the ability to receive should involve a second knowledgeable individual.	Consistent with the soft recommendation provided by the External Auditor prior to 2016, IA also recommends there should be adequate segregation of duties. Contracts and Procurement stated that with recent retirements and new hires the conflict will be resolved and eliminated. IA will verify during follow-up evaluation planned for FY 2017.
Contracts and Procurement Follow-Up August 29, 2012	2	For all grant-related procurements, the Contracts and Procurement Department should print the confirmations from the debarment website at the time the vendor debarment is verified. The confirmation should be filed as evidence of verification, to show whether a vendor was debarred or not at the time of the procurement.	Contracts implemented this added procedure during our audit. IA will verify the practice continues during follow-up evaluation of randomly selected files, a review is planned for FY 2017.
2013 Petty Cash May 31, 2013	1	IA recommends that Accounting and Fiscal Management Department personnel should take the lead in working with the responsible Agency personnel in making revisions and updates to the following Agency policies: A-02, A-75, A-68 and A-34.	IA will verify during follow-up evaluation planned by June 2017.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
2013 Petty Cash May 31, 2013	3	IA recommends that monthly fund reconciliations be performed by personnel independent of the petty cash reimbursement processes and that the fund reconciliation subsequently be reviewed and signed by the Petty Cash Custodian's supervisor or manager as required by SOP CM PR-13, "Cash Management Procedures-Petty Cash", further ensure all Petty Cash Custodians understand the requirements of the SOP.	IA will verify during follow-up evaluation planned by June 2017.
2013 Petty Cash May 31, 2013	4	IA recommends that either a new SOP be developed or the current SOP CM PR-13, "Cash Management Procedures-Petty Cash" be updated to include detailed procedures over the entire petty cash reimbursement processes.	IA will verify during follow-up evaluation planned by June 2017.
2013 Petty Cash May 31, 2013	5	IA recommends that Accounting and Fiscal Management review current petty cash reimbursable budget codes within SAP and develop a "Master Listing" of budget codes or "roles" within SAP for all Petty Cash Custodians to have access to and utilize them when coding expenditures.	IA will verify during follow-up evaluation planned by June 2017.
2013 Petty Cash May 31, 2013	6	IA recommends that Accounting and Fiscal Management evaluate the petty cash needs of each location throughout the Agency and make any necessary adjustments to the petty cash assignments.	IA will verify during follow-up evaluation planned by June 2017.
SCE Utility Payments August 28, 2013	1	P&EC and Maintenance Management should work with the City of Chino and SCE to adequately transfer the electricity expense related to City of Chino property. The street lights in front of IEUA's HQ-A building have been identified by the Agency and SCE as the financial responsibility of the City of Chino. It was noted that over \$900.00 a year is paid for the street lights expense. P&EC and Maintenance previously identified this issue and had initiated discussions to transfer the account and related expense to the City of Chino. It is anticipated that by the end of calendar year 2013 this will be resolved.	IA will verify during follow-up evaluation planned for FY 2017.
SCE Utility Payments August 28, 2013	2	CAP management should evaluate the entire CAP Department staff's responsibilities and leverage all department resources to achieve all tasks and at the same time avoid internal control conflicts. In addition, IA recommends that SAP authorized access be modified for employees as noted in the report section "SAP Segregation of Duties – CAP Personnel" to address existing internal control conflicts identified. The report details the specific conflicts. This has previously been recommended in prior CAP Follow-Up Audit Reports dated May 24, 2010 and August 29, 2012.	IA will verify during follow-up evaluation planned for FY 2017.
SCE Utility Payments August 28, 2013	3	CAP personnel should take the lead in working with the responsible Agency personnel to make the necessary updates to Agency policies A-32 (Authority to Contractually Commit the Agency) and A-33 (Request and Evaluation of Proposals), and department specific SOP's.	IA will verify during follow-up evaluation planned for FY 2017.
Accounts Payable Follow-Up Audit August 29, 2013	1	AFM and BIS need to work together to ensure users have appropriate access within SAP based on job responsibilities and remove/modify access privileges that are not necessary to reduce the risk of unauthorized transactions and SOD conflicts. All user access should be immediately removed when an employee resigns his/her position with the Agency.	IA to verify during follow-up evaluation.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Accounts Payable Follow-Up Audit August 29, 2013	2	Access to the Vendor Master File (VMF) should only be granted to one Manager/Supervisor for AFM and CAP department with only one back up employee, if necessary, due to Segregation of Duties conflict. This is a standard best practice across many industries. Furthermore, we recommend access be removed from all other current and past employees.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	3	AFM department should institute controls to ensure payment of invoices by the due date.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	4	AFM should work with the appropriate Agency personnel to update Agency policies and remind employees of the requirements of Agency Policy A-12, Employee Personal Computer Purchase Program; Policy A-37, Reimbursement for Attendance at a Conference, Seminar or Meeting; Policy A-50, Non-Purchase-Order Invoice Approval Procedures; Policy A-55, Agency Credit Cards; and Agency Policy A-14 Vehicle Use.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	5	Human Resources department, in conjunction with Information Support Systems, should ensure that loans for personal computers are not approved for items not covered by the loan program as described in Agency Policy A-12. Additionally, consider revising Agency Policy A-12 to clarify the applicability of the computer loan program to tablet computers and operating systems other than Microsoft Windows.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	6	AFM department should strengthen Vendor Master File procedures to establish uniformity in entering, altering and deleting vendors, and to provide guidelines for the maintenance of vendors, to ensure vendors are authorized, including the requirement that a supervisor or manager in FMD CAP approve additions, deletions, or changes to vendors.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	7	AFM department should ensure all new vendors provide a current, physical business address for the Vendor Master File. Additionally, AFM should establish a plan to update the master file for all active vendors that do not currently have a physical address on file.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	8	AFM department should work with BIS to test the features of SAP related to purging inactive vendors. Upon successful completion of the testing, AFM should identify vendors with no activity in the previous three to five years and deactivate or delete from the Vendor Master File as appropriate.	IA to verify during follow-up evaluation.
Accounts Payable Follow-Up Audit August 29, 2013	9	AFM department should update all SOPs to reflect business process changes resulting from the implementation of the Agency's ERP SAP system.	IA to verify during follow-up evaluation.
Automobile Insurance Requirements March 3, 2014	1	IA recommends that the Contracts and Facilities Department: Take the lead to review and update and/or consolidate the existing Agency Policy A-14 "Vehicle Use Policies and Procedures" and A-36 "Automobile Insurability and Driver's License Requirements for Current and Prospective Employees." The policies should define and specify the requirements for employees to maintain personal automobile insurance, clarify the coverage limits and any other responsibilities and provisions. Ensure policy updates and requirements are communicated to all employees.	IA to verify during follow-up evaluation.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Automobile Insurance Requirements March 3, 2014	2	IA recommends that the Contracts and Facilities Department: Consider developing an appropriate "Acknowledgment Statement" form or other verification/certification document or process that outlines and verifies the requirements of the Agency's policies related to personal automobile insurance coverage and driver's license. Determine the need to require all employees sign the acknowledgement/verification document each year as a certification that the employee understands and accepts responsibilities when driving a personal or Agency vehicle.	IA to verify during follow-up evaluation.
Vehicle Security Procedures March 3, 2014	1	CAP should take the lead to properly inventory and account for all assigned and unassigned gate transmitters. CAP should continuously work with department managers who request gate transmitters to monitor and revise access based on staff duties and responsibilities. CAP should promptly deactivate any improperly assigned/unassigned gate transmitters or for those employees and contractors that <u>separate employment from the Agency.</u>	IA to verify during follow-up evaluation.
Vehicle Security Procedures March 3, 2014	2	CAP should ensure the appropriate signed gate transmitter form is maintained on file for all issued gate transmitters. Additionally, CAP should ensure the employee/contractor who is issued a gate transmitter understands the requirements of Agency Policy A-24 "Issuance and Inventorying of Gate Transmitters and Keys to Agency Facilities, Vehicles and/or Equipment." This can be done at the time the employee/contractor is issued the gate transmitter via the signed form and is provided <u>a copy of the Agency policy.</u>	IA to verify during follow-up evaluation.
Vehicle Security Procedures March 3, 2014	3	IA recommends CAP staff inventory all Certificates of Title and work to locate or replace the missing titles for Agency vehicles. Additionally, CAP should implement and communicate the proper procedure to ensure that all Certificates of Title are promptly submitted to Records Management for filing and retention.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	1	Maintenance Department and HR Department should work together to develop and/or consolidate into one updated policy, the proper procedures for refueling Agency vehicles in order to streamline processes and clearly define the procedures for refueling Agency vehicles. Specifically, the policy should include: payment method, when to fuel, and specify if the requirement applies to assigned, pool or all vehicles. Take the lead to review and update and/or consolidate the existing Agency Policy A-14 "Vehicle Use Policies and Procedures" and A-36 "Automobile Insurability and Driver's License Requirements for Current and Prospective Employees." The policies should define and specify the requirements for employees to maintain personal automobile insurance, clarify the coverage limits and any other responsibilities and provisions. Ensure policy updates and requirements are communicated to all employees.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	2	Maintenance Department should take the lead to update Agency Policy A-86, "Refueling Agency Vehicles" to include a clear definition of a "pool" versus an "assigned" vehicle and these definitions should be carried across all Agency policies that relate to Agency vehicle procedures.	IA to verify during follow-up evaluation.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Vehicle Inventory Procedures March 12, 2014	3	Maintenance Department should revise Agency Policy A-86 to specifically address how Voyager fuel cards for Agency "pool" vehicles will be issued and used by employees in order to establish separate guidelines for Agency "pool" vehicles.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	4	Maintenance Department should work with Business Information Systems (BIS) to develop an online/electronic "vehicle reservation and approval process." Approval should be obtained through the online/electronic process by either the employee's supervisor or manager. If the travel in an Agency "pool" vehicle will be for the calendar day only, online/electronic approval obtained from the employee's direct supervisor is sufficient. If travel utilizing an Agency "pool" vehicle will be overnight or several nights, or outside the service area, the employee should obtain online approval from the responsible manager and/or a member of Executive Management.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	5	Maintenance Department should work with the HR Department to incorporate mileage limitations and/or geographic boundaries (i.e. out-of-state) for Agency vehicles in updated Agency policies.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	6	Maintenance Department should evaluate the overall purpose of the VIF, to determine what elements are necessary to be reported by employees after use of an Agency vehicle, as well as determine what elements to hold the employee accountable for. Additionally, fewer incomplete forms may be returned if wording is revised to require only exceptions (an example might be: "Indicate damage to vehicle, if any").	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	7	Maintenance Department should determine the need to require that the VIF include an area for the employee's direct supervisor/manager to approve and sign, specifically acknowledging where the vehicle will be used and permitting the use of the Agency vehicle, prior to checking out the vehicle as an added control and accountability measure for the vehicle and the employee.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	8	Maintenance Department should ensure the recipients of the VIF (currently, the receptionists) no longer accept incomplete VIF forms from an employee upon the return of the vehicle to Headquarters. The receptionist should return the form to the employee and request they fill out the VIF completely before checking-in the vehicle.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	9	Maintenance Department should continue to work with "Voyager Fleet Systems" and U.S. Bank to review the card issuer's reporting capabilities, in order to develop the reports needed with the appropriate inputs (e.g. odometer readings, date of purchase, amount, credit card number, cardholder name, number of gallons purchased at point-of-sale) so that the Agency can perform a thorough analysis of fuel consumption monthly.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	10	Maintenance Department should develop one policy or update the existing policy (ies) to outline the proper procedures for washing Agency vehicles.	IA to verify during follow-up evaluation.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for implementation & Comment
Vehicle Inventory Procedures March 12, 2014	11	Maintenance Department should perform a routine inventory as well as regular safety/maintenance inspections for all Agency vehicles at least annually and ensure necessary safety and emergency equipment is available and operational. Issues identified should be addressed and corrected timely. Specifically, items required for safety reasons such as fire extinguishers, insurance information and accident instructions, etc. should be current and readily available in the vehicle. Documented maintenance and safety inspection results should be retained and placed in the vehicle's file as evidence of examination.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	12	Maintenance Department should consider including a vehicle bumper sticker on all Agency vehicles that display the Agency's logo and a hotline or contact phone number where issues may be reported by any member of the public.	IA to verify during follow-up evaluation.
Vehicle Inventory Procedures March 12, 2014	13	Periodic reconciliations for fleet (vehicles and equipment) should be performed by the Maintenance Department between any report(s) or system databases that are utilized by management to ensure accuracy when reporting fleet information and making decisions regarding fleet.	IA to verify during follow-up evaluation.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Regional Contract Review - Final Report December 16, 2015	Overall	Consider legal, political and financial impacts of governing by ordinance vs. contract	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	Overall	Review and revise EDU formula	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	Overall	Resolve identified differences of over/under collected amounts of Connection fees and identified differences of over/under collected amounts of unreported monthly sewerage fees	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.

Regional Contract Review - Final Report December 16, 2015	1	Connection Fees: Centralize the permitting process OR IEUA provides final sign-off and plumbing permit approval for all nonresidential entities.	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	2	Connection Fees: IEUA should establish monitoring program to inspect random facilities and those were there is a suspected discrepancy	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	3	Connection Fees: Contract should include IEUA inspection, verification and recourse rights for under-collected/under-reported Connection Fees	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	4	Connection Fees: Contract should include IEUA right to audit, full cooperation and access to records and documents upon request	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	5	Connection Fees: Two tier connection fees process that distinguishes between common features and unique features (i.e., a toilet always costs the same regardless of type of business)	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	6	Connection Fees: Update Exhibit J regularly to include new/evolving business types	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	7	Connection Fees: Update & clarify Fixture Unit descriptions of Exhibit J regularly	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	8	Connection Fees: Standardize calculation worksheet to ensure it is consistent with Exhibit J and consistent region-wide	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	9	Connection Fees: IEUA should require copies of calculation worksheets for all nonresidential customers along with the monthly Building Activity Reports.	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	10	Connection Fees: Regular workshops, meetings, plant tours, etc. with staff in Building, Plan Check and Utility Billing/Financial Departments	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	11	Connection Fees: IEUA develop fixture count expertise and provide regular/ongoing training for Contracting Agencies - Building Departments	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Regional Contract Review - Final Report December 16, 2015	12	Connection Fees: Contracting Agency internal review of Connection Fees as part of preparing the Building Activity Report	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	1	Monthly Sewerage: Collect monthly sewerage fees for the entire region through County's property tax roll	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	2	Monthly Sewerage: Evaluate methodology used for billing monthly sewerage fees (residential and commercial) and consider alternatives by water consumption, EDUs purchased or other methodology	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	3	Monthly Sewerage: Standardize monthly report to provide IEUA automated, itemized listings of non-residential monthly sewerage charges	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	4	Monthly Sewerage: Establish contract for monthly sewerage payments from Contracting Agencies rather than IEUA issuing monthly invoices	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	5	Monthly Sewerage: IEUA exercise inspection, verification and recourse rights for under-collected/under-reported monthly sewerage fees	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	6	Monthly Sewerage: Contract should include IEUA right to audit, full cooperation and access to records and documents upon request	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	7	Monthly Sewerage: Update 1997 billing memorandum regularly for new business types to provide detailed definitions and descriptions	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	8	Monthly Sewerage: Create a correlation between monthly sewerage fees and Connection Fees	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	9	Monthly Sewerage: Add billing guidance for locations with multiple types of businesses serviced by a master meter	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	10	Monthly Sewerage: Bill commercial businesses at least a minimum of one EDU per month	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	1	Public Service Facility: Consider legal, political and financial impacts of excluding Public Service Facilities from Connection Fees and monthly sewerage charges.	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	2	Public Service Facility: Consider legal, political and financial impacts of IEUA assuming responsibility for Connection Fees calculations, collections and CCRA accounts	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	3	Public Service Facility: Contract should include IEUA inspection, verification and recourse rights for under-collected/under-reported Connection Fees	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.

**Pre-2016 Outstanding Audit Recommendations
March 2017**

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Regional Contract Review - Final Report December 16, 2015	4	Public Service Facility: Contract should include IEUA right to audit, full cooperation and access to records and documents upon request	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	5	Public Service Facility: Address difference between "Publicly Owned" vs. "Publicly Used"	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.
Regional Contract Review - Final Report December 16, 2015	6	Public Service Facility: Consider cross-departmental approach to the development review process as a regional model	Recommendation to be addressed as part of the Renegotiation of the Regional Contract. IA will follow-up at that time.

Total of 71 outstanding recommendations from 2015 and prior requiring IA verification and/or supported response as of March 6, 2017 .

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Master Trade Contracts, dated September 1, 2016	1	IA recommends that even in instances where a difference department has primary responsibility for the proposal evaluation process, CFS work with the end-user department to ensure the information is communicated to the Board of Directors accurately reflects the signed contract terms. Additionally, CFS should determine the need to request from the evaluating department the evaluation documentation, or a staff memo summarizing the selection process and have it available/filed.	Both CAP and CM stated they would begin steps to implement. IA to verify during a future follow-up evaluation.
Master Trade Contracts, dated September 1, 2016	2	IA recommends that CFS work with BIS to research built-in tools within SAP to implement automated controls necessary to ensure that spending on contracts and groups of contracts do not exceed Board approved limits and determine the cost benefit of implementing those monitoring tools.	Both CFS and BIS stated they would work together to evaluate implementation. IA to verify during a future follow-up evaluation.
Master Trade Contracts, dated September 1, 2016	3	IA supports and encourages the initiative to fully implement the Agency's Enterprise Content Management System (ECMS) - Laserfiche. CFS should continue to work closely with BIS to implement the Agency's ECMS - Laserfiche to assist with the organization and centralizing of contract documents, facilitate research and access to information, streamline recordkeeping and eliminate multiple copies of the same documents.	Both CFS and BIS stated they would work together to evaluate implementation. IA to verify during a future follow-up evaluation.
Master Trade Contracts, dated September 1, 2016	4	IA recommends that CFS enhance communications about the Agency's ethical procurement responsibilities and expectations to all Agency employees as well as Agency vendors and contractors to actively foster an ethical procurement environment. CFS should consider creating an ethics outreach plan and developing an approach with Agency Executive Management and Human Resources about reinforcing the "tone at the top" to actively remind employees and contractors/vendors about the Agency's ethical expectations including once again providing annual notifications of ethical guidelines to vendors and staff. Agency management may also want to incorporate references to the Agency's Ethics Hotline and Ethics Point "FAQs" in that communication.	CFS stated they would research the best approach and begin steps for implementation. IA to verify during a future follow-up evaluation.
Master Trade Contracts, dated September 1, 2016	5	IA recommends CFS staff attend annual training related to ethics in their respective procurement activities.	CFS reported that all staff attended ethics training related to procurement activities shortly after the audit and will plan to attend training annually. IA to verify during a future follow-up evaluation.
Master Trade Contracts, dated September 1, 2016	6	In addition to the cross-training that is already occurring, IA suggests that CFS consider the potential benefits of job rotation within the CFS department as a training and internal control technique with multiple benefits.	CFS stated that they would evaluate and determine the need for rotation since currently there have been various retirements and changes. IA to verify during a future follow-up evaluation.
Audit of Master Service Contracts, dated December 14, 2016	1	Emergency projects are classified according to three levels. Level 3 emergencies are the least urgent and the work can be scheduled on a time-table set by the Agency. E&CM and CFS should consider establishing clear criteria that differentiate between a "Level 3" emergency procurement and routine minor construction and repairs procurements and/or determine and document whether the "Level 3" designation is necessary.	CM stated they would begin implementation. IA to verify during a future follow-up evaluation.

2016 Audit Recommendations Issued

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
Audit of Master Service Contracts, dated December 14, 2016	2	To ensure that the Agency communicates sufficient information about emergency procurement activity, E&CM and CFS should consider developing and providing a comprehensive monthly update of emergency procurements for the Board. The information to consider could include the current month emergency procurement activity and a year-to-date total. It may also be useful to compare current year-to-date emergency procurement activity in dollars and numbers of task orders to prior years and to the total budget. Trends can be analyzed and comparisons can be made to ensure that the Agency's infrastructure is well maintained and emergency procurements are kept to a minimum.	CM stated they would begin implementation. IA to verify during a future follow-up evaluation.
Audit of Master Service Contracts, dated December 14, 2016	3	To ensure that contracts for Repairs and Minor Construction operate as intended, E&CM and CFS should consider developing specific criteria and/or additional guidance and definitions about what constitutes repairs or minor construction as compared to projects for prequalified contractors for contracts less than \$2 million. An additional control would be to consider establishing dollar maximums within the contract or the group of contractors to provide assurance that the contracts are being utilized as intended and spending is constrained.	CM stated they would begin implementation. IA to verify during a future follow-up evaluation.
Follow-Up Review - Information Technology Equipment Audit, dated December 5, 2016	1	FAD should take the lead to ensure a physical inventory and inspection of the Agency's IT fixed assets is completed on a periodic basis to verify existence, location, and working condition of assets.	FAD agrees with IA and the External Auditors recommendation and would evaluate implementation. IA to verify during a future follow-up evaluation.
Follow-Up Review - Information Technology Equipment Audit, dated December 5, 2016	2	FAD should evaluate the Agency's current capitalization thresholds for IT equipment and determine if these need to be increased to ensure current practice meets policy and are consistent with current trends.	IA to verify during a future follow-up evaluation.
IT Equipment August 21, 2012 (December 21, 2016 Follow-Up)	15	FMD should implement adequate controls to ensure that the stated capitalization policy for IT equipment is consistently followed to ensure that all items meeting the capitalization threshold are capitalized and to ensure that items not meeting the capitalization threshold are not capitalized.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.
IT Equipment August 21, 2012 (December 21, 2016 Follow-Up)	17	FMD should implement adequate controls to ensure that asset records established in SAP are accurate and complete, such as ensuring that all data fields in SAP are completed and ensuring that only those items allowed by the capitalization policy are capitalized.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.
IT Equipment August 21, 2012 (December 21, 2016 Follow-Up)	19	FMD should return incorrect or incomplete Project Closure Authorization Forms to the Project Manager for proper completion. FMD should also provide training to Project Managers on the importance of proper completion and instructions on completing the form.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.
IT Equipment August 21, 2012 (December 21, 2016 Follow-Up)	22	FMD should document Standard Operating Procedures to address the functions of setting up capital assets such as procedures for completing the SAP asset information, compliance with stated capitalization thresholds, and processing of Project Closure Authorization Forms.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.

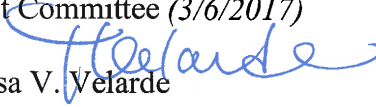
2016 Audit Recommendations Issued

Audit Performed	Rec #	Internal Audit Recommendation	Target for Implementation & Comment
IT Equipment August 21, 2012 (February 29, 2016 Follow-Up)	3	ISS implement appropriate tracking systems that include relevant information on IT purchases (i.e., serial numbers, etc.), are updated timely and are complete and accurate. ISS should establish procedures to enter, modify, and delete information in the tracking systems that address areas such as timeliness for updates, responsibilities for maintaining the systems, and the types of items included in the tracking system.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.
IT Equipment August 21, 2012 (February 29, 2016 Follow-Up)	1	ISS should ensure that any services procured with P-cards are expressly authorized by the Manager of CAP, CFO, AGM, or GM prior to committing to services.	Additional time is required for full implementation. IA will re-verify during follow-up evaluation.

Total of 17 outstanding recommendations from 2016 requiring IA verification and/or supported response as of March 6, 2017 .

Audit Committee

INFORMATION
ITEM
2C

Date: March 15, 2017
To: The Honorable Board of Directors
Through: Audit Committee (3/6/2017)
From: 
Teresa V. Velarde
Manager of Internal Audit
Subject: Internal Audit Department Status Report for March 2017

RECOMMENDATION

This is an information item for the Board of Directors.

BACKGROUND

The Audit Committee Charter requires that a written status report be prepared and submitted each quarter. The Internal Audit Department Status Report includes a summary of significant internal and external audit activities for the reporting period. Attached is the Status Report for March 2017.

The Status Report is consistent with the Agency's Business Goals of Fiscal Responsibility, Workplace Environment and Business Practices by describing IA's progress in providing independent evaluations of Agency financial and operational activities and making recommendations for improvements.

PRIOR BOARD ACTION

On June 15, 2016, the Board of Directors approved the Annual Audit Plan for Fiscal Year 2016/17.

On December 16, 2015, the Board of Directors reconfirmed the amended Audit Committee and Internal Audit Charters.

IMPACT ON BUDGET

None

Internal Audit Department Status Report for March 2017

Project: Filing of the Annual Financial Statements and Single Audit Report

Scope: Submit the required audited financial reports to the requesting reporting authorities

Status: **IN PROGRESS – Required Filing of Financial & Single Audit
COMPLETE – both Audits are complete**

Completing the required filing with the State Controller's Office, the San Bernardino Auditor-Controller and the State Water Resources Control Board is mandatory and IEUA must complete filing by March 31st, 2017. Internal Audit Department takes the lead to file the Financial and Single Audit with the required agencies. Final Board of Director approval and authorization is necessary to complete the filing. Both Audit reports have now been completed and provided to us by the External Auditor. As discussed during the December Audit Committee and Board Meetings, the Single Audit was being delayed pending the state's determination of grant funds as either state or federal funding. The State has provided final totals, therefore, LSL was able to finalize the Single Audit on February 24th. Upon approval, Internal Audit will file the required reports by the legal deadline. The Single Audit Report is being presented as an Action item separately through this Agenda. This item has been discussed in detail and at length by Deborah Harper, CPA of LSL during the December meetings.

Project: Regional Contract Review – Follow up: Communication, Collections & Centralization

Scope:
To continue to report the results of the Regional Contract review and pursue region-wide agreement and settlement of findings in conjunction with the renegotiation of the Regional Contract.

Status: **COMPLETE – Final Report and all prior reports
ON-GOING – Agreement & Settlement of Findings/Recommendations**

Internal Audit was asked to participate in a meeting with representatives from the City of Upland to discuss billing issues discovered by the City of Upland in their bi-monthly volumetric sewerage billing system. Upland representatives asked to postpone the meeting because City representatives needed additional time to investigate.

Internal Audit continues to be involved in discussions with outside counsel and representatives from Planning and Environmental Resources and from Finance and Accounting to discuss findings from the Regional Contract Review and potential collection strategies and related issues.

Reports related to the Regional Contract Review include:

Final Report-Regional Contract Review	Complete	December 2015
City of Ontario	Complete	September 2015
Cucamonga Valley Water District	Complete	March 2015
City of Chino	Complete	December 2014
City of Fontana	Complete	December 2014
City of Montclair	Complete	September 2014
City of Upland	Complete	September 2014
Review of the Ten-year Forecast	Complete	June 2014
Comparable Agency Survey Report	Complete	June 2014
Survey of Comparative Information	Complete	September 2014

Internal Audit stands ready to be of assistance to any Agency department as the Agency pursues renewal, renegotiation and/or other approaches towards the extension/continuance of the Regional Contract and/or with implementation of the recommendations and/or resolution of the unpaid fees identified.

Internal Audit Department Status Report for March 2017

On-going Projects

Project: Water Conservation Programs Audit

Scope: To evaluate water conservation programs of the Agency, to evaluate whether IEUA effectively uses its resources for the execution of the programs, additionally to evaluate internal controls over programs as required by executed contracts, State laws, Agency policies and grant requirements and determine opportunities to improve the administration of the programs.

Status: IN PROGRESS

IA has begun reviewing the processes in place and the supporting documentation for the activities involving Water Conservation Programs. A key measure included in the Governor's Drought declaration directed the California Department of Water Resources to accelerate funding for projects that enhance water supplies. Such funding is mostly in the form of grants; some received by IEUA. IEUA is the intermediary between State/Federal and Metropolitan Water District programs and member agencies. In partnership with other water agencies, IEUA has been at the forefront of various conservation projects working with member agencies to increase awareness about the drought and the need for conservation. Projects administered by IEUA must be carried out in accordance with the requirements of the grants, etc. This evaluation is reviewing internal controls with contract administration/execution and appropriate distribution of funding.

Proposed Completion: Planned complete turf-removal program review by June 2016

Project: Management Requests

Scope:

Assist Agency Management with requests for analysis, evaluations and verification of information, assist with the interpretation of policies and procedures, and/or provide review and feedback on new policies or procedures. These services are provided according to the IA Charter, the Annual Audit Plan, and best practices.

The management request projects are short-term projects, typically lasting no more than 60 – 75 hours each where IAD determines it has the necessary staff, skills and resources to provide assistance without having to delay/defer scheduled audits and priority projects. The scope of each review is agreed upon between the department manager requesting the evaluation/review/analysis/assistance and the Manager of IA and when deemed appropriate by Executive Management.

During this quarter, IA was working on the following "Management Requests":

- Continue to be involved with possible collection of the identified uncollected Connection Fees.
 - Make recommendations about Maintenance, Construction Management and Contracts and Procurement Departments' concern/issue about a purchase requisition in excess of contract limits
 - Participate in IT Security Committee
 - Participate in the Safety Committee
-

Internal Audit Department Status Report for March 2017

Status: On-Going

Internal Audit Department

Internal Audit Department Staffing:

The Internal Audit Department is staffed as follows:

- 1 Full-time Manager of Internal Audit
- 2 Full-time Senior Internal Auditors

Internal Audit Staff Professional Development Activities:

As required by the *International Standards for the Professional Practice of Internal Auditing*, auditors should continue to enhance their knowledge, skills, and other competencies through continuing professional development.

The Internal Audit Manager is a member of the governing board of the Inland Empire Chapter of the Institute of Internal Auditors. The governing board sets direction for the chapter and provides guidance on seminar topics and activities sponsored by the association.

During the past quarter, IA staff has continued to stay abreast of industry developments through review of industry periodicals and participation in on-line webinars. In February 2017, one Senior Internal Auditor attended an all-day seminar on Fraud sponsored by the Inland Empire Chapter of the Institute of Internal Auditors.

Additionally, the Manager of IA was requested as a guest lecturer for a 1-hour presentation on Leadership at an IIA seminar in San Bernardino and a 3-hour session on practical experiences in Internal Auditing to a Masters of Accountancy class at Cal Poly Pomona, evening class.

All three IA members are preparing for the third exam of the 3-part Certified Internal Auditor (CIA) certification examination. The CIA is the only globally-recognized certification for internal audit professionals and is the highest certification that can be attained by an internal auditor. One Senior Auditor is a Certified Public Accountant (CPA). One Senior Auditor is a Certified Government Audit Professional (CGAP).

Future Audit Committee Meetings:

- Monday, June 12, 2017 – Regularly Scheduled Audit Committee Meeting
- Monday, September 11, 2017 – Regularly Scheduled Audit Committee Meeting
- Monday, December 11, 2017 – Regularly Scheduled Audit Committee Meeting