TELECONFERENCE JOINT MEETING

FOR

STUDENT AID COMMISSION AUDIT COMMITTEE
and
EDFUND AUDIT COMMITTEE

September 26, 2007
1:30 p.m.

CALIFORNIA STUDENT AID COMMISSION

EDFUND®

TELECONFERENCE JOINT MEETING FOR STUDENT AID COMMISSION AUDIT COMMITTEE and EDFUND AUDIT COMMITTEE

3300 Zinfandel Drive
Rancho Cordova, CA 95670

Dean Johnston, Chair of Commission Audit Committee
Fritz Weis, Chair of EDFUND Audit Committee

September 26, 2007
1:30 p.m.

OPEN SESSION	AGENDA ITEMS	SPEAKER	TIME	TAB
Information	Call to Order and Roll Call	Sandy Byram Gloria Lopez	1:30 p.m.	
	Public Comment (Public Comment will also be invited prior to any open session Committee action)			
Information/Action	Audit Chairs' Reports	Dean Johnston Fritz Weis	1:35 p.m.	
Information/Action	Approval of Minutes for June 27, 2007	Diane Manning Tina Kilgore-Goodwin	1:40 p.m.	1
Information	Discussion of Internal Control Considerations by Audit Committees	Diane Manning Tina Kilgore-Goodwin Tina Treis, Perry-Smith	1:45 p.m.	2
Information/Action	Presentation of the June 30, 2007, Audited Operating Fund and Federal Fund Financial Statements	Tina Treis, Perry-Smith	2:05 p.m.	3

The Committees will adjourn from Open Session to Closed Session ***to discuss and possibly take action on business matters of a proprietary nature pursuant to California Education Code 69525(g). At the conclusion of the Closed Session, the Committees will reconvene in Open Session to make any required report and conclude discussion of any remaining items.***

Information	External Audit Update	Diane Manning Tina Kilgore-Goodwin	2:35 p.m.	4
Information	Internal Audit Update	Diane Manning Tina Kilgore-Goodwin	2:40 p.m.	5
Information	Legal Update	Cathy Reynolds	2:50 p.m.	6
	ADJOURN		**3:00 p.m.**	

The times for topics are approximate. The actual times may be sooner or later than the estimates given, depending on how quickly the Committees proceed with its business.

NOTE: Items designated for information are appropriate for the Committees' action if the Committees wish to take action. Any agenda item acted upon at this Committee meeting may be brought to the full Commission and/or Board at a regularly scheduled meeting.

1

Information/Action Item

Joint Meeting of the CSAC and EDFUND Audit Committees

Approval of June 27, 2007 Minutes

Minutes of the joint meeting of the CSAC and EDFUND Audit Committees held on June 27, 2007 are provided for the Committees' review and approval.

Recommended Action:

Approval of minutes.

Responsible Staff: Diane Manning
Tina Kilgore-Goodwin

DRAFT

STUDENT AID COMMISSION AND EDFUND AUDIT COMMITTEES JOINT TELECONFERENCE MEETING

10811 International Drive
Rancho Cordova, CA 95670

June 27, 2007

Committee Members Present:

EDFUND Audit Committee
Fritz Weis, EDFUND Audit Committee Chair
Sally Furay, EDFUND Audit Committee Member
Molly Greek, EDFUND Audit Committee Member

Commission Audit Committee
Dean Johnston, Commission Audit Committee Chair
Dennis Galligani, Commission Audit Committee Member

Others Present:

Tina Treis, Perry-Smith

Staff Present:

Sam Kipp, EDFUND President
Diane Manning, EDFUND Vice President Audit Services Division
Tina Kilgore-Goodwin, EDFUND Assistant Vice President Audit Services Division
Martin Scanlon, EDFUND CFO, Vice President Finance & Administration Division
David Reid, EDFUND General Counsel/Vice President Legal Services Division
Kathy Lynch, Commission Counsel
Keith Yamanaka, Chief Deputy Director
Kathleen Stanley, Federal Policy & Programs Division Staff
Wendi Dodgin, Federal Policy & Programs Division Staff
Intania Alcoran, Federal Policy & Programs Division Staff
Gloria Lopez, Commission Liaison
Sandy Byram, EDFUND Board Liaison

CALL TO ORDER

EDFUND Audit Chair, Fritz Weis, called the meeting to order at 9:05 a.m. The roll was called and a quorum for each committee was established.

AUDIT CHAIRS' REPORT

Chair Weis and Chair Dean Johnston stated that there were no chair reports.

PUBLIC COMMENT

Chair Weis asked if there was any public comment. There being none, Chair Weis moved on to the other agenda items.

APPROVAL OF MINUTES FOR NOVEMBER 21, 2006 and JANUARY 26, 2007

Chair Weis asked for a motion to approve the minutes of the November 21, 2006 and January 26, 2007 joint meetings of the Commission and EDFUND Audit Committees. Member Sally Furay MOVED to APPROVE the minutes of November 21, 2006 and January 26, 2007 as presented for the EDFUND Audit Committee. Chair Weis SECONDED the motion. Member Dennis Galligani MOVED to APPROVE the minutes of November 21, 2006 and January 26, 2007 as presented for the Commission Audit Committee. Chair Johnston SECONDED the motion. The MOTION CARRIED from both committees with member Dennis Galligani abstaining for the November 21, 2006 minutes.

PERRY-SMITH AUDIT APPROACH PRESENTATION

Tina Treis, the Perry-Smith LLP audit partner, presented the firm's independent audit approach to conducting the financial statement audits of the EDFUND 401(k) for the year ended December 31, 2006, the Operating Fund and Federal Fund for the year ending June 30, 2007 and EDFUND for the year ending September 30, 2007.

Ms. Treis informed the Committee members of the auditor's responsibilities under generally accepted auditing standards in conducting the audits; Perry-Smith's reporting requirements to the Audit Committees, the new accounting standards, the timing of the audits, and the independence requirements of the auditors. Ms. Treis also discussed fraud risks with the members of the Committees and asked if the members were aware of any fraudulent activities. Both Chairs stated that they were not aware of any such activity. Ms. Treis indicated that once the audits are completed, the Perry-Smith auditors will meet again with the Audit Committees to discuss the results of the audits.

EDFUND's Vice President of Audit Services, Diane Manning, requested an approval from the Committees of Perry-Smith's audit approach. Member Molly Greek MOVED to approve Perry-Smith's audit approach for the EDFUND Audit Committee and member Sally Furay SECONDED and the motion CARRIED unanimously. Chair Dean Johnston MOVED to approve Perry-Smith's audit approach for the Commission's Audit Committee and member Dennis Galligani SECONDED and the motion CARRIED unanimously.

SAS 70 AUDIT DISCUSSION

Ms. Manning informed the members of the Committees that the Bureau of State Audits (BSA) has reported for the past few years that the Commission could require an audit of EDFUND's systems, often referred to as a SAS 70 audit. She also stated that there is no law that requires such an audit. She also stated that the new Operating Agreement requires this audit to be conducted if the California Department of Finance approves the expenditure.

Tina Treis explained to the members of the Committees that this type of audit is typically conducted for service providers whose internal controls are relied upon by multiple external organizations. A payroll service company, such as ADP, was an example provided by Ms. Treis.

There was a discussion regarding the costs, timing and staff resources for such an in-depth audit. Ms. Manning indicated that, with the pending sale of EDFUND and the workload that will result, such an audit may not be feasible until spring or summer 2008 and should coincide with the Operating Fund and Federal Fund fiscal year end. No action was taken.

EXTERNAL AUDIT UPDATE

Ms. Manning reported that BSA is currently reviewing EDFUND and CSAC's implementation of the 2006 performance audit recommendations. She also stated that a separate BSA audit team has started the annual FFEL Program compliance audit and that the compliance audit results would be issued in March or April 2008. Ms. Manning also stated that Perry-Smith was in the process of conducting the EDFUND 401(k) Plan financial statement audit for the year ended December 31, 2006 and has started the planning process for the June 30, 2007 Operating Fund and Federal Fund financial statement audit.

INTERNAL AUDIT UPDATE

Ms. Manning and Tina Kilgore-Goodwin provided a summary report of EDFUND Internal Audit activities performed from January 26, 2007 through June 26, 2007 and provided a tracking spreadsheet to keep the Committees informed of overall progress in conducting the planned audits that were approved by the Committees in November 2006.

LEGAL UPDATE

EDFUND'S General Counsel David Reid reported four outstanding cases. Two cases involved defaulted borrowers that believed their loans should be discharged due to bankruptcy. Another is an on-going case that involves a teacher stating that she could not afford to repay her defaulted loan. The fourth case is also an on-going matter with a borrower arguing that their former employer promised to pay their loan on the individual's behalf. Mr. Reid said he was aware of two matters regarding fair credit practices but that EDFUND has not been served on these cases. There were no legal matters to report from the Commission per Kathy Lynch.

ADJOURNMENT

With no further business to discuss, Member Furay MOVED to adjourn the Committees' meeting and Chair Johnston SECONDED, the motion CARRIED unanimously. The meeting was ADJOURNED at 10:25 a.m.

____

Fritz Weis, EDFUND Audit Committee Chair

____

Dean Johnston, Commission Audit Committee Chair

2

Information Item

Joint Meeting of the CSAC and EDFUND Audit Committees

Discussion of Internal Control Considerations by Audit Committees

During the June 27, 2007 meeting of the Audit Committees, Tina Treis with Perry-Smith, suggested that the members read a document prepared by the American Institute of Certified Public Accountants (AICPA) titled *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* which was written as a guide for all audit committees. The document was sent to the members of the Committees later that day and it is included under tab 2. Internal Audit also prepared a two page summary highlighting key aspects cited in the document which is also included under tab 2 at the request of Audit Chair Weis.

Recommended Action:

No action pertaining to this agenda item is required.

Responsible Staff: Diane Manning
Tina Kilgore-Goodwin
Tina Treis, Perry-Smith

Summary of Points to Garner from the AICPA *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* Guide for Audit Committees

A. Background

1) Fraud in financial reporting involves intentionally misstating the nature and timing of transactions and account balances.

2) Most frequent types of management fraud in financial reporting include:
   - Fictitious or premature revenue recognition
   - Overstated assets and understated expenses and/or liabilities by exploiting accounting estimates.

3) Management is primarily responsible for the design, implementation, and maintenance of internal controls. Management's override of internal controls is very difficult to detect.

4) An organization's board and its audit committee are responsible for overseeing the actions of management.

B. Guidance to audit committees suggested in the document

1) Maintain an appropriate level of skepticism
   - Set aside any beliefs about the integrity of management because override is often committed by "good executives gone bad" rather than consistently dishonest people

2) Understand the entity's business and industry (to identify factors that may create incentives or pressures for engaging in fraud)
   - Understand management's processes in developing, reviewing, and revising budgets.
   - Understand what may threaten management's ability to accomplish its objectives and strategies including competition, capital constraints, major customer or vendor loss, production issues, economic downturn, or regulatory change.
   - Understand management's compensation package and the entity's incentive compensation programs.

3) Determine if the organization has mechanisms in place to prevent, deter, or detect management override of internal controls
   - Consider the organization's culture or attitudes about ethical behavior and how management communicates this to its employees
   - Obtain the results of surveys of employees regarding corporate behavior and similar information received from external parties such as customers and vendors
   - Determine whether the entity has a vigorous whistleblower program. The audit committee should receive automatic and direct information of complaints involving senior management (without filtering by management or other personnel). The audit committee's primary interest should be complaints related to accounting, internal controls, and auditing.

4) Develop a broad information and feedback network

   - Communications with Internal Auditors

     - The internal audit department should understand that its responsibilities are primarily to the audit committee.

     - Executive sessions with the head of internal audit at every audit committee meeting provides the audit committee an opportunity to engage in candid discussion with him or her about the possible risk of management override of internal controls and any indications of improper conduct by senior management.

   - Communications with Independent Auditors

     - The audit committee should be responsible for appointing the independent auditors.

     - The independent auditors should report directly to the audit 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.

   - 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.

   - Communications With Key Employees (including the entity's general counsel, compliance or security director, human resources department, marketing or sales department, and other key business unit leaders)

     - General counsel – He or she is typically aware of potential violations of laws and regulations, violations of the entity's code of conduct, or pressures that management may be experiencing.

     - Human resources department – 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 calls about human resources issues may be valuable sources of information regarding management integrity and the tone at the top.

     - Sales, marketing and other key employees – Revenue recognition is almost always a fraud risk. Periodic conversations with the appropriate employees about company policies and controls over revenue generating activities may reveal pressures to meet revenue targets and possible inappropriate behavior.

AICPA

American Institute of Certified Public Accountants

MANAGEMENT OVERRIDE OF INTERNAL CONTROLS:

The Achilles' Heel of Fraud Prevention

The Audit Committee and Oversight of Financial Reporting

NOTICE TO READERS

The purpose of this 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 controls. If the reader would like to learn more about management antifraud programs and controls, please see the document titled *Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud*.[1]

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.

[1] The American Institute of Certified Public Accountants, the Association of Certified Fraud Examiners, Financial Executives International, Information Systems Audit and Control Association, Institute of Internal Auditors, Institute of Management Accountants, and Society for Human Resource Management jointly issued *Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud*. That document contains specific recommendations an organization's board of directors, audit committees, and management can take to prevent, deter, and detect fraud and can be downloaded from http://www.aicpa.org/download/antifraud/SAS-99-Exhibit.pdf. The document was also included as an exhibit to Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

Antifraud Programs and Controls Task Force

Ronald L. Durkin, *Chair*
KPMG LLP

Dan L. Goldwasser
Vedder, Price, Kaufman, & Kammholz, PC
Audit Committee member

Mark Beasley
North Carolina State University

Ronald B. Norris
The Estée Lauder Companies Inc.

Toby J.F. Bishop
Association of Certified
Fraud Examiners

Zoe-Vonna Palmrose
University of Southern California

David Cotton
Cotton & Company LLP

Thomas M. Stemlar
Arthur Andersen LLP (retired)
Audit Committee member

George P. Fritz
PricewaterhouseCoopers LLP (retired)
Accounting & Auditing Consultants LLC

AICPA Staff

Charles E. Landes
Director
Audit and Attest Standards

Michael P. Glynn
Technical Manager
Audit and Attest Standards

Acknowledgments

The AICPA Antifraud Programs and Controls Task Force would like to thank several individuals who assisted in providing the guidance in this document by agreeing to review and comment on the guidance provided herein before its issuance. Those individuals include Charles Bowsher (former Comptroller General of the United States), Todd DeZoort, Ph.D. (Accounting Advisory Board Fellow, The University of Alabama), Les Hand (Forensic Partner, KPMG LLP), Timothy Hedley, Ph.D. (Forensic Partner, KPMG LLP), David L. Landsittel (Arthur Andersen LLP, retired, audit committee member, and former chair of the Auditing Standards Board), Robert D. Neary (Ernst & Young LLP, retired, audit committee member, and former chair of the Quality Control Inquiry Committee), and Mark F. Zimbelman, Ph.D. (Accounting Professor, Brigham Young University).

The task force would also like to thank the following AICPA staff: Richard Miller, General Counsel, John Morrow, vice-president, New Finance, and Anat Kendal, director, Financial Planning, for taking the time to review this document and assist in ensuring the document is distributed to those who would benefit from the guidance. Also, the task force would like to thank Jane Mancino, a former technical manager from the AICPA Audit and Attest Standards Team, who spent many hours considering the guidance that should be included in the document.

Table of Contents

The risks of fraud and management's ability to override internal controls 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 controls 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 controls—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 controls? *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 begin 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 controls 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 controls. 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 controls 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 controls—the Achilles' heel of fraud prevention.

Because management is primarily responsible for the design, implementation, and maintenance of internal controls, 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 controls is combined with powerful incentives to meet accounting objectives, senior management may engage in fraudulent financial reporting. Thus, otherwise effective internal controls 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 board 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 corporation's internal controls, both in theory and in practice, and to take actions, such as those described in this document, to minimize the possibility that internal controls 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/ethics, training programs, expanded auditing and public reporting on the effectiveness of internal controls now required by the Sarbanes-Oxley Act of 2002 (the 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.[1] The audit committee must evaluate whether oversight mechanisms are in place and functioning that will prevent, deter, or detect management override of internal controls. Furthermore, recent changes in 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.[2]

[1] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control—Integrated Framework states on page 6 that, "An internal control system, no matter how well conceived and operated, can provide only reasonable—not absolute—assurance to management and the board regarding achievement of the entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the reality that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by collusion of two or more people, and ***management has the ability to override the system***." (*Emphasis added*).

[2] 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.

Section B: Actions to Address the Risk of Management Override of Internal Controls

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 controls. 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 controls, the audit committee should 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 controls. 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

Today's 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 controls 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 should 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 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[3] 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.

[3] These three elements constitute the "fraud triangle." According to generally accepted auditing standards (AU sec. 316.07):

> Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or ***the ability of management to override controls***—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act. Some individuals possess an *attitude*, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The greater the incentive or pressure, the more likely the individual will be able to rationalize the acceptability of committing fraud (*Emphasis added*).

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.

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 controls 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 above 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, compliance officer, marketing/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.

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 should attempt to 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, and 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.[4] 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 should 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

[4] As a result of the Sarbanes-Oxley Act of 2002, Section 406, the Securities and Exchange Commission set rules requiring registrants to disclose whether or not the issuer has adopted a code of ethics for its senior executive officers and if not, why not.

and/or 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 controls. 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 controls is a whistleblowing process that typically incorporates a telephone hotline. Respondents to a 2004 survey by the Association of Certified Fraud Examiners (ACFE) revealed that various forms of fraud are detected 40 percent of the time by tips, which made this the leading method for detecting fraud.[5] Although the Sarbanes-Oxley Act[6] 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.[7]

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 controls, 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 controls, 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,

---

[5] Association of Certified Fraud Examiners, *2004 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: ACFE, 2004), p. 18.

[6] A whistleblowing hotline is now 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, a statutory responsibility that they did not have before.

[7] Association of Certified Fraud Examiners, *2004 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: ACFE, 2004), p. 19.

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. A checklist of issues for audit committees to consider when evaluating the design and operating effectiveness of the whistleblower process can be found in the Audit Committee Effectiveness Center at www.aicpa.org/audcommctr/homepage.htm.

Developing a Broad Information and Feedback Network

Identifying situations where management has overridden internal controls 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 controls. 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 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 controls 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 controls.

Communications With Internal Auditors

First and foremost, the internal audit department should 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 should 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 controls 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?
2. What specific procedures does internal audit perform to address management override of internal controls?
3. Has anything occurred that would lead internal audit to change its assessment of the risk of management override of internal controls?

Communications With Independent Auditors

Sarbanes-Oxley requires that the independent auditors be appointed by the audit committee. As a best practice, all audit committees—even those not subject to Sarbanes-Oxley—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 controls.

Specific inquiries might include the following:

1. What fraud risks are independent auditors addressing through audit procedures?
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 precipitate anything that heightened the independent auditors' professional skepticism?
4. What are the results of audit procedures designed to address the risk of management override of internal controls?

Additionally, the audit committee should 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.[8] The audit committee members should 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.[9]

---

[8] See Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316.41).

[9] SAS No. 99 requires that the independent auditor, among other things, perform a discussion among engagement personnel regarding the risks of material misstatement due to fraud and to identify the risks of material misstatement due to fraud.

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

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. Preemployment 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 calls 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 controls.

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 controls to fraudulently report financial results related to business unit operations. Business unit leaders may also be aware of senior management activities to override internal controls performed at the business unit level for purposes of fraudulently reporting financial results at the consolidated level.

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 controls 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 controls.

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 controls is present in every entity. Although the guidance provided in this document cannot guarantee that the audit committee will prevent, deter, or detect fraud through management override of internal controls, the implementation of these suggestions should 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 types of management fraud involved fictitious or premature revenue recognition. These frauds have occurred, for example, by management overriding or circumventing controls to record sales not based on firm orders to buy or not based on the true contract terms and conditions. For goods requiring shipment, shipments may then have been held or directed to an intermediate location, or the recorded sales may have been cancelled in a subsequent period. True contract terms and conditions hidden or falsified by management have involved side agreements, future or continuing seller obligations, rights of return, and cancellation and refund provisions. Using related parties has been another method used by management to circumvent or override controls and recognize fictitious revenue or to prematurely recognize revenue.

Research has also found that another frequent type of management fraud involved overstated assets and understated expenses and/or liabilities. For these management may have exploited accounting estimates and, for example, undervalued allowances for bad debts, loan losses, or inventory reserves, failed to recognize or underestimated asset impairments, misstated merger-related reserves, or simply failed to accrue liabilities.

Additionally, 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 controls. 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 examples are based on a study by Sarah Bonner, Zoe-Vonna Palmrose, and Susan Young, “Fraud Type and Auditor Litigation: An Analysis of SEC Accounting and Auditing Enforcement Releases.” *The Accounting Review*, vol. 73, no. 4 (October 1998): 503-532.

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):
   — 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?

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 controls 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 nonowner managed business) without compensating internal controls?
   - Ineffective oversight over the financial reporting process and internal controls?
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 controls, including automated controls and controls over interim financial reporting (where external reporting is required)?

— 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?

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?

3

Information/Action Item

Joint Meeting of the CSAC and EDFUND Audit Committees

Presentation of the June 30, 2007 Operating Fund and Federal Fund Audited Financial Statements

Perry-Smith LLP has completed their independent audit of the Operating Fund and Federal Fund financial statements for the year ended June 30, 2007. The auditors will make a formal presentation to the Audit Committees on the financial statements, related correspondence, and the results of the audit.

Recommended Action:

Formal acceptance of the Operating Fund and Federal Fund audited financial statements for the year ended June 30, 2007.

Responsible Staff: Tina Treis, Perry-Smith

4

Information Item

Joint Meeting of the CSAC and EDFUND Audit Committees

External Audit Update

BSA has completed their follow-up review on the 2006 performance audit recommendations and released their report on September 18, 2007.

Another BSA audit team is currently on site performing the annual Federal Family Education Loan (FFEL) Program compliance audit for the year ended June 30, 2007. BSA's findings from this audit will be reported in their statewide compliance report in March or April 2008.

Perry-Smith has completed the December 31, 2006 EDFUND 401(k) Plan financial statement audit and the June 30, 2007 Operating Fund and Federal Fund financial statement audit. The firm has completed its planning phase of the EDFUND September 30, 2007 financial audit and has been conducting pre-year end audit tests. The majority of the test work for this audit is performed after year end and the audited financial statements will be presented to the Audit Committees in January 2008.

Recommended Action:

No action pertaining to this agenda item is required.

Responsible Staff: Diane Manning
Tina Kilgore-Goodwin

5

Information Item

Joint Meeting of the CSAC and EDFUND Audit Committees

Internal Audit Update

A summary is provided which describes the completed audits, audits in progress and other activities performed by EDFUND's Internal Audit staff during the period of June 27, 2007 through September 26, 2007.

A tracking spreadsheet is also provided to keep the Committees informed of overall progress in conducting the audits approved by the Audit Committees in November 2006.

Recommended Action:

No action pertaining to this agenda item is required.

Responsible Staff: Diane Manning
Tina Kilgore-Goodwin

Internal Audit Activities Update
June 27, 2007 through September 26, 2007

Audits Completed

Policy 009

Internal Audit issued its Compliance Review of Policy 009: *Employment of Applicants and Employees with Guaranteed Student Loans* on July 30, 2007.

Policy 009 incorporates key internal controls at the time a candidate is being considered for employment and throughout an individual's ongoing employment with EDFUND. This test work is performed annually by EDFUND's Internal Audit Department. No compliance exceptions were identified during this year's review.

Data Maintenance Update Process

Internal Audit issued its *Data Maintenance Update Process Review report* on August 15, 2007. Data maintenance updates refers to the process of adding, deleting, or modifying borrower and loan data directly in EDFUND's Financial Aid Processing System (FAPS) database. Data maintenance is only intended to be used when a systematic means to perform such transactions is not available using the standard FAPS data entry screens. Data maintenance update users directly update borrower or loan data without being subject to the types of edits associated with the standard FAPS data entry screens because, by system design, certain edits would otherwise inappropriately prevent valid update transactions from posting. Additionally, an audit trail is not created in the system when a data maintenance update is performed.

This audit included a review of data maintenance changes for proper authorization and accuracy as well as determining whether staff complied with documented procedures when performing data maintenance transactions. Additionally, Internal Audit assessed whether proper supporting documentation is maintained for data maintenance update transactions.

As part of this review, Internal Audit identified opportunities to help strengthen internal controls related to performing data maintenance transactions by establishing processes and procedures for monitoring and evaluating data maintenance transactions to help identify solutions that will reduce the number of transactions performed and improving the tracking of such transactions. Additionally, Internal Audit recommended enhancing the existing quality control processes to include a sampling and review of all types of data maintenance transactions performed. Internal Audit also recommended that documentation be retained evidencing the required approvals for all data maintenance transaction types.

Application Change Management

Internal Audit released its *Application Change Management Review* report on September 12, 2007. This audit included an evaluation of the processes in place for authorizing, coordinating and controlling changes to EDFUND's Financial Aid Processing System and Oracle Financials, the two primary computer applications utilized by

EDFUND to track and report borrower loan data as well as the financial activities and account balances of EDFUND and the Loan Program.

In carrying out this review, Internal Audit tested various application development projects to determine if changes were properly approved and adequately tracked and tested prior to implementing the changes to the production environment.

Internal Audit identified opportunities to help strengthen internal controls related to the application change management process by recommending that a process be established to periodically review the appropriateness of access permissions granted to individuals performing application changes and remove any unnecessary accounts and/or access. Additionally, Internal Audit recommended enhancing the existing procedures and standards for administering and testing application development projects to help ensure consistency and accountability across all development projects, including those applications acquired from third party software vendors. Internal Audit also recommended that the authorization to migrate program code to the production environment occur only after successful completion of testing. Currently, there are instances where a request authorizing the migration is approved prior to the completion of the testing although the program code is not actually migrated until the testing is finalized.

Audits in Progress

Collection Cost Recovery

Federal regulations permit guaranty agencies to charge borrowers who have defaulted on their loans an amount equal to reasonable costs incurred by the agency in collecting on the loans within prescribed limits. This internal audit includes a review of EDFUND's collection cost rate calculations as well as how collection costs are applied against a borrower's loans.

Internal Audit has completed the test procedures associated with this audit and is in the process of finalizing the draft report. The audit report is anticipated to be issued in early October 2007.

User Access

This is an audit of the appropriateness of personnel access to the Financial Aid Processing System (FAPS) and Oracle Financials based on their job responsibilities. As part of this audit, Internal Audit is testing the procedures for requesting, establishing, issuing, and terminating user accounts and access rights. Internal Audit is also evaluating the processes in place for periodically reviewing and validating the appropriateness of access rights.

Internal Audit is currently executing the test procedures associated with this audit. The audit report is anticipated to be issued in October 2007.

Follow-Up Activities on Completed Audits

Internal Audit performs follow-up audit activities to evaluate management's progress towards implementing the recommended actions identified as part of previously issued internal audit reports. The status of each recommended action is determined based on discussions with key personnel, observing procedures performed, and/or reviewing supporting documentation. The follow-up audits conducted during the current reporting period included:

Network Security

This follow up review was completed on June 29, 2007. Four of the nine recommendations made by Internal Audit have been addressed as of the date of the follow up.

Of the five recommendations that remain open; two involve enhancing the existing passwords and login controls and implementing additional controls when processing requests from users to reset their network passwords. Two open recommendations involve the deletion of dormant/inactive accounts identified by Internal Audit during the audit and follow up review and the need for establishing a quarterly process to monitor dormant/inactive accounts. The last open recommendation involves performing an analysis to determine if automated logging tools should be implemented to proactively monitor network components.

Internal Audit will perform a second follow up in February 2008 to determine if these items have been addressed. At that time, if it is determined that the recommended actions have not been completed and that the resulting level of risk assumed by management is unacceptable as a result of not addressing such items, the VP of Audit Services will escalate the matter to the President.

NSLDS Reporting and Lender Portfolio Reconciliation

This follow up review was completed on July 31, 2007. One of the three recommendations by Internal Audit had been addressed as of the date of the follow up.

The two items that remain open are related to enhancing the procedures for resolving errors from the NSLDS submission process and defining the required documentation that must be maintained to support the research and resolution of NSLDS errors. At the time of Internal Audit's follow up review, the procedures had been revised but had not yet been implemented; therefore, Internal Audit could not perform tests to verify whether staff were complying with the newly revised procedures.

Internal Audit will perform a second follow up in November 2007 to determine if these items have been addressed. At that time, if it is determined that the recommended actions have not been completed and that the resulting level of risk assumed by management is unacceptable as a result of not addressing such items, the VP of Audit Services will escalate the matter to the President.

Other Activities

Development of the Internal Audit Risk Assessment and Audit Plan

Audit Services management and staff are developing the Internal Audit Plan and Risk Assessment for the two year audit cycle (Fiscal Years 2007 - 08 and 2008 - 09). This plan and risk assessment helps identify the highest risk areas from an audit standpoint and assists in determining how to deploy internal audit staff for the next two years. This plan will be presented to the Audit Committees for approval during the next Audit Committee meeting.

Quality Assurance Review Preparation

One of the audit recommendations in the 2006 BSA Performance Audit Report stated that an external assessment of the Internal Audit unit should be performed to ensure compliance with the Institute of Internal Auditors' audit standards. Internal Audit anticipates engaging the services of an independent reviewer to conduct an external review of its audit activities by the end of the third quarter of federal fiscal year 2007-08.

Audit Services management and staff continue its efforts in documenting and implementing additional internal audit processes, procedures and tools to prepare for the external assessment.

Internal Audit Activity Tracking Spreadsheet
September 26, 2007

The chart below summarizes Internal Audit's progress towards completing the audit activities on the revised audit plan for Fiscal Years 2005-06 and 2006-07 as approved by the Commission and EDFUND Audit Committees in November 2006. The audit statuses that are shaded reflect updated activities since June 26, 2007, the last tracking spreadsheet presented to the Audit Committees.

Internal Audit Activities	Audit Status	
	2005 - 06	**2006 - 07**
A. Follow- Up Reviews On Previously Issued Audits		
Data Center Operations – Follow Up Five of Internal Audit's six recommendations cited in the audit report issued in September 2005 were addressed as of the date of the initial follow up. Internal Audit performed a second follow up in December 2006 and determined that the remaining recommendation remained incomplete. As a result, the VP of Audit Services escalated this item was to the President for resolution. This item, however, was subsequently resolved by the appropriate parties prior to requiring any action by the President. All actions recommended have now been addressed, therefore, this audit is considered closed.	**Initial Follow Up Complete**	**Second Follow Up Complete; Audit Closed**
Default Claims Adjudication – Follow Up All actions recommended in the audit report issued in June 2005 have been addressed, therefore, this audit is considered closed.	**Follow Up Complete; Audit Closed**	
External Collections – Follow Up All actions recommended in the audit report issued in March 2005 have been addressed, therefore, this audit is considered closed.	**Follow Up Complete; Audit Closed**	

Internal Audit Activities	Audit Status	
	2005 - 06	**2006 - 07**
<u>Internal Collections – Follow Up</u> All actions recommended in the audit report issued in July 2005 have been addressed, therefore, this audit is considered closed.	**Follow Up Complete; Audit Closed**	
<u>Manual Borrower and Loan Status Updates – Follow Up</u> All actions recommended in the audit report issued in August 2005 have been addressed, therefore, this audit is considered closed.	**Follow Up Complete; Audit Closed**	
<u>Manual Journal Entry Process – Follow Up</u> Internal Audit performed an initial follow up review in December 2006. As of the date of the follow up, only two of the five items recommended in the audit report issued in September 2005 had been implemented. Three of the five open items involve developing and implementing comprehensive processes and procedures for processing manual journal entries, including defining the acceptable types of documentation that must be maintained as support for the journal entries. Internal Audit performed a second follow up in March 2007. All remaining actions recommended by Internal Audit were implemented at that time; therefore, Internal Audit considers this audit closed.		**Initial and Second Follow Ups Complete; Audit Closed**
<u>Network Security – Follow Up</u> Four of the nine items cited in the audit report issued in May 2006 were addressed as of the date of the initial follow up in June 2007. Of the five items that remain open, two involve enhancing the existing passwords and login controls and implementing additional controls when processing requests from users to reset their network passwords. Two open recommendations involve the deletion of dormant/inactive accounts identified by Internal Audit during the audit and follow up review and the need for establishing a quarterly process to monitor dormant/inactive accounts. The last open recommendation involves performing an analysis to determine if automated logging tools should be implemented to proactively monitor network components. Internal Audit will perform a second follow up in February 2008 to determine if these open items have been addressed.		**Initial Follow Up Complete: Second Follow Up Scheduled**

Internal Audit Activities	Audit Status 2005 - 06	Audit Status 2006 - 07
Post Default Loan Discharges – Follow Up All actions recommended in the audit report issued in September 2006 have been addressed at the time of the follow up review, therefore, this audit is considered closed.		**Follow Up Complete; Audit Closed**
NSLDS Reporting and Lender Portfolio Reconciliation – Follow Up One of the three items cited in the audit report issued in June 2006 was addressed as of the date of the initial follow up in July 2007. The two remaining items are related to enhancing the procedures for resolving errors from the NSLDS submission process and defining the required documentation that must be maintained to support the research and resolution of NSLDS errors. At the time of Internal Audit's follow up review, the procedures had been revised but had not yet been implemented; therefore, Internal Audit could not perform tests to verify whether staff were complying with newly revised procedures. Internal Audit will perform a second follow up in November 2007 to determine if these two open items have been addressed.		**Initial Follow Up Complete: Second Follow Up Scheduled**
Property Survey Review – Follow Up All actions recommended in the audit report issued in January 2005 have been addressed, therefore, this audit is considered closed.	**Follow Up Complete; Audit Closed**	
Remittance Process – Follow Up Internal Audit performed an initial follow up review in December 2006. At that time, only two of the four recommendations in the audit report issued in September 2005 had been implemented. Of the two items that remained open; one involved enhancing the remittance process to require all incoming cash receipts to be processed in dual custody. Finance staff modified their procedures to require processing receipts in dual custody, but had not yet fully implemented the revised procedure as of the date of Internal Audit's follow up review. The second open item addressed developing and implementing a companywide process for requesting, approving and processing manual adjustments to borrowers' accounts, referred to as "CMOs". Internal Audit performed a second follow up review in March 2007. All remaining actions recommended by Internal Audit were implemented at that time; therefore, Internal Audit considers this audit closed.		**Initial and Second Follow Ups Complete; Audit Closed**

Internal Audit Activities	Audit Status	
	2005 - 06	**2006 - 07**
<u>Table Maintenance – Follow Up</u> Internal Audit performed an initial follow up review in March 2006 to ensure that the recommendations identified as part of this audit had been implemented. At that time, only three of the eight recommendations Audit had been addressed. The remaining items, which involved developing and implementing companywide processes and procedures for performing and reviewing table maintenance activities and developing tools and implementing processes to facilitate user access reviews, had not been implemented. Therefore, Internal Audit performed a second follow up in October 2006. All remaining actions recommended by Internal Audit were implemented; therefore, Internal Audit considers this audit closed.	**Initial Follow Up Complete**	**Second Follow Up Complete; Audit Closed**

Internal Audit Activities	Audit Status	
	2005 - 06	2006 - 07
B. High Risk Audits		
<u>Budget Development and Management</u> During FY 2005-2006, the Finance and Administration Division implemented the budget module in Oracle Financials, which eliminated a number of manual processes previously performed in developing the budget. Additionally, the implementation of zero based budgeting helped strengthened internal controls by requiring management to provide detailed justifications for virtually all expenses. Budgets are subject to extensive levels of review by AVPs, VPs, EMT, the Finance Committee, the Board of Directors, Commission staff, and the Commission. As a result, Internal Audit determined that budget development and management are not a high risk area but will re-evaluate these activities when developing the next two year internal audit plan.		**No Longer Considered Necessary For This Two Year Audit Plan**
<u>Business Continuity Management Program</u> This audit report was issued March 7, 2007. An initial follow-up review is planned to be conducted in December 2007 by Internal Audit to evaluate management's implementation of the audit recommendations. Internal Audit anticipates that a second follow up will be necessary which will be scheduled once the initial follow up is conducted.		**Complete**
<u>Application Change Management</u> This audit report was issued September 12, 2007. A follow-up review is planned to be conducted in May 2008 by Internal Audit to evaluate management's implementation of the audit recommendations.		**Complete**
<u>Collection Cost Recovery</u> This audit was rescheduled to FY 2006-07 due to audit resource constraints with the resignation of a Senior Internal Auditor during FY 2005-06. Internal Audit has completed the test procedures associated with this audit and is in the process of finalizing the draft report.		**In Progress**

Internal Audit Activities	Audit Status	
	2005 - 06	2006 - 07
<u>Data Maintenance Update Process (Loan Operations and Default Mgmt)</u> This audit report was issued August 15, 2007. A follow-up review is planned to be conducted in January 2008 by Internal Audit to evaluate management's implementation of the audit recommendations.		**Complete**
<u>Electronic Borrower and Loan Status Updates</u> Internal Audit completed the NSLDS Reporting and Lender Portfolio Reconciliation review and released the audit report on October 25, 2006 The NSLDS audit addressed key internal controls that would have been tested again during the Electronic Borrower and Loan Status Updates audit. Audit Services Management, therefore, determined that an audit of electronic borrower and loan status updates would not provide significant additional assurances. Internal Audit will re-evaluate these business activities when developing the next two year audit plan.		**No Longer Considered Necessary For This Two Year Audit Plan**
<u>AR Form 2000 Reporting</u> This audit was started during the last quarter of FY 2005-06 and was issued April 11, 2007. An initial follow-up review is planned to be conducted in July 2007 and a second follow up during the first quarter of FY 2008-09 by Internal Audit to evaluate management's implementation of the audit recommendations.		**Complete**
<u>Information Security Program</u> EDFUND experienced turnover in the Information Security Officer position during FY 2005-06 and again in FY 2006-07. EDFUND currently has a consultant providing information security services on a fulltime basis and is in the process of building a new team. As a result, Internal Audit deferred this audit to provide the new security office an opportunity to refine the Information Security Program. Internal Audit anticipates conducting this audit during the next two year audit cycle which ends September 30, 2009.		**Deferred to Subsequent Year**
<u>Loan Guarantee Process</u> Audit Services Division management redirected the Senior Information System Auditor scheduled to perform this audit to assist with the technical components of two CSAC Cal Grant audits in FY 2005-06. The Auditor was also redirected to support the Business Continuity Management Program and Loan Transfer audits during FY 2006-07 due to the need for his technical expertise. Data files have been obtained to conduct the Loan Guarantee audit; however, the data has not yet been analyzed to determine the specific audit objectives. This audit will be a carry-over audit that will be completed in FY 2007-08.		**Scheduled for Completion**

Internal Audit Activities	Audit Status	
	2005 - 06	2006 - 07
<u>Loan Transfer Process</u> This audit was started during FY 2005-06; however the Senior Internal Audit assigned to the effort resigned from EDFUND prior to completing the audit. By the time Internal Audit management filled this vacancy and was prepared to resume the audit, the business unit impacted by this audit requested that the effort be postponed to FY 2006-07 due to workload issues with which Audit Services Division management concurred. This audit was restarted during the first quarter of FY 2006-07 and the audit report was issued on May 29, 2007. An initial follow-up review is planned to be conducted in October 2007 by Internal Audit to evaluate management's implementation of the audit recommendations.		**Complete**
<u>Manual Journal Entry Process</u> Audit complete; report released on June 23, 2006.	**Complete**	
<u>Network Security</u> Audit complete; report released on July 7, 2006. This audit was initially scheduled for completion during FY 2006-2007, however, Internal Audit accelerated the timing of this effort due to the rescheduling of the Data Maintenance audit.	**Complete**	
<u>NSLDS Reporting and Lender Portfolio Reconciliation</u> Audit completed at the end of FY 2005-06 and was issued in draft to EDFUND's Loan Operations Division in September 2006 to complete validation and provide management responses. The report was then released to the Audit Committees on October 25, 2006.	**Complete**	
<u>Post Default Loan Discharges</u> Audit complete; report released on September 26, 2006.	**Complete**	
<u>User Access</u> Internal Audit is currently executing the test procedures associated with this audit. The audit report is anticipated to be issued in October 2007.		**In Progress**

Internal Audit Activities	Audit Status	
	2005 - 06	2006 - 07
Voluntary Flexible Agreement (VFA) The auditors from USED Region 9 completed an extensive review of the existing VFA in August 2006 and issued their audit close out letter in October 2006. The only required action from this USED audit was to transfer $7,000 in Account Maintenance Fees from the Operating Fund to the Federal Fund due to an overpayment. The finding was clearly immaterial. Additionally, USED has not renegotiated new VFAs with any of the guaranty agencies. As a result, Internal Audit intends to defer this audit and will consider this area when developing the next two year audit plan.		**Deferred to Subsequent Year**
Wage Garnishments and Tax Offsets This internal audit was initially scheduled for completion during FY 2006-07. Management in the Default Management Division, the business unit impacted by this audit, recently requested that this audit be postponed to FY 2007-08 as they are actively working on a project to further enhance and automate the existing wage garnishment processes. Default Management does not expect this project to be implemented until late July 2007 at the earliest. If Internal Audit were to conduct this review as initially scheduled, Default Management and Audit Service Division management agree that any audit findings and recommendations related to the existing processes may not be relevant or add value once the new process is in place. Consequently, this audit will be deferred to FY 2007-08.		**Deferred to Subsequent Year**

Internal Audit Activities	Audit Status	
	2005 - 06	**2006 - 07**
C. Required Audits		
Conflicts of Interest Legal Counsel is now reporting any reported conflicts of interest directly to the Audit Committees as a standing agenda item; therefore, Internal Audit is no longer performing this activity.	**No Longer an Internal Audit Activity**	**No Longer an Internal Audit Activity**
Policy 009 Compliance – *Employment of Applicants and Employees with Guaranteed Student Loans* This is a recurring annual compliance audit performed by Internal Audit. The audit report applicable to FY 2005-06 was released on August 9, 2006 and the report applicable to FY 2006-07 was released on July 27, 2007. No compliance exceptions were identified by Internal Audit during these two audits.	**Complete**	**Complete**
Quarterly Review of Transactions on Employee FFEL Loans Internal Audit performs this review each quarter. This review stems from a BSA compliance audit finding which stated the need for additional controls to prevent employees from modifying or deleting their own records. Management's response to this finding stated that Internal Audit would periodically sample and review system activity on loans associated with EDFUND employees. Internal Audit does not issue audit reports summarizing the results of each quarterly review. Instead, the audit procedures performed and the results are included as part of the Policy 009 Compliance audit report. The reviews for FY 2005-06 and FY 2006-07 have been performed by Internal Audit.	**Complete**	**Complete**

6

Information Item

Joint Meeting of the CSAC and EDFUND Audit Committees

Legal Update

The Audit Committees have requested that they be briefed at each meeting regarding any legal matters resulting from the normal course of business that may be pending.

Recommended Action:

No action pertaining to this agenda item is required.

Responsible Staff: Cathy Reynolds