12.a

Action/Information Item

California Student Aid Commission

Consideration of Response to the Bureau of State Audits Report

The Commission will be provided under separate cover the one year draft response to recommendations made by the Bureau of State Audits in the audit report dated April 2006. Questions and/or comments about the response will be discussed.

Recommended Action: No specific action is recommended.

Responsible Staff: Diane Manning, EDFUND
Vice-President of Audit Services

12.b

Action/Information Item

California Student Aid Commission

Consideration of Policies and Procedures for Commission and EDFUND Meetings

The Bureau of State Audits (BSA) April 2006 report recommended that the Commission and EDFUND establish policies and procedures to help ensure that closed sessions are conducted within the board's authority as required by state law. These policies and procedures should provide the board and staff with clear guidelines in defining trade secrets and business proprietary information that can be discussed during closed sessions. In response to BSA's recommendation, the Commission established a process that requires EDFUND to maintain minutes of its closed sessions and make the confidential minute book available for monitoring by the Commission.

In February 2007, Commission staff, in consultation with Deputy Attorney General Kathy Lynch and Commissioner Dan Friedlander, developed draft policies and procedures for closed session meetings for the Commission and EDFUND Board.

At the February 22-23, 2007 meeting, after consideration of the proposed closed session policies and procedures and the concerns of both Commission and EDFUND staffs, the Commission directed both legal counsels to develop a unified and consistent policy applicable to both entities. As a result, Ms. Lynch and Mr. Reid have developed the enclosed overarching policy for Commission and EDFUND Board meetings.

At its April 9, 2007 meeting, the EDFUND Board of Directors approved the proposed policy for recommendation to the Commission.

Recommended Action: Approve the proposed overarching policy for Commission and EDFUND Board meetings.

Responsible Staff: Kathy Lynch
Deputy Attorney General
Attorney General's Office
Department of Justice

David Reid
General Counsel and Vice President
EDFUND Legal Services

CALIFORNIA STUDENT AID COMMISSION
50 Years Serving Students 1955-2005

GENERAL POLICY

SUBJECT:
Meetings

POLICY NUMBER:
01

EFFECTIVE DATE:

APPROVED BY COMMISSION SECRETARY

Introduction

The California Student Aid Commission ("the Commission") as a state body is subject to the Bagley Keene Open Meetings Act ("the Act" or "the Bagley–Keene Act") set forth in Government Code sections 11120-11132. The EDFUND Board of Directors ("EDFUND") is also subject to the Bagley-Keene Act under Education Code section 69525, subdivision (g)(1). Generally, the Act requires the respective organizations[1] to publicly notice their meetings, prepare agendas, accept public testimony and conduct their meetings in public unless specifically authorized to meet in closed session by the Act or Education Code section 69525, subdivision (g)(2) and (3).

Below is a list of some of the items that may properly be considered in closed session by either the Commission, EDFUND or their respective standing and ad hoc committees. While this list may be a helpful guide, it is no substitute for consulting the actual language of the Act, section 69525, and any court cases and administrative opinions that may interpret these statutes.

Potential Matters for Closed Session

Proprietary

As a general rule, all items placed on an agenda must be addressed in open session. However, the Legislature has allowed closed session in very limited circumstances. Education Code section 69525, subdivision (g)(2) and (3), respectively, allow EDFUND and the Commission to separately hold a closed session to consider a matter of a proprietary nature the discussion of which would disclose a trade secret or proprietary business information that could potentially cause economic harm to EDFUND or cause EDFUND to violate an agreement with a third party to maintain the information in confidence if that agreement was made in good faith and for reasonable business purposes.

[1] The term "organization" as used in this policy refers to either the Commission or the EDFUND Board of Directors.

The following is a list of subjects commonly addressed by either the Commission or EDFUND in their respective closed session meetings under Education Code section 69525, subdivision (g)(2) or (3). This list is not intended to limit or mandate the subjects that may be discussed in closed session under this subdivision. Whether a subject falls within this subdivision, is a factual matter to be determined on a case-by-case basis by the respective organization's legal counsel.

- Discussions of trade secrets or confidential or proprietary information may include, but is not limited, to the following:

  - Internal financial statements
  - Any non-public financial reports
  - Cash flow statements
  - Annual Loan Program Business Plan and Budget
  - Federal Family Education Loan (FFEL) Program statistical reports
  - Voluntary Flexible Agreement (VFA) negotiations
  - Development of business diversification opportunities and plans
  - Review of a Commission draft report on EDFUND's Annual Performance Review. The content of this report should be examined closely to ensure that it relates to confidential proprietary information under Education Code section 69525, subdivision (g)(2).

Civil Code section 3426.1, subdivision (d)(1)(2), defines a trade secret "as information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and (2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

(Education Code section 69525, subdivision (g); Civil Code section 3426.1, subdivision (d)(1)(2).)

<u>Audits</u>

- The Commission and EDFUND may each meet in closed session to discuss their respective responses to any confidential final draft audit report received from the Bureau of State Audits. However, once the Bureau of State Audits publicly releases an audit report, each organization must meet in open session to discuss the audit report unless exempted from that requirement by some other provision of law.

(Government Code section 11126.2.)

<u>Employees</u>

- The Commission may meet in closed session to consider the appointment, employment, evaluation of performance, discipline or dismissal of the Commission Executive Director or any other public employee of the Commission. However, any discussion of the amount of compensation must be discussed in open session.

- EDFUND may meet in closed session to consider the appointment, employment, evaluation of performance, discipline or dismissal of the EDFUND President or EDFUND employees. However, any discussion of the amount of compensation must be conducted in open session. [2]

(Government Code section 11126, subdivision (a).)

Advice of Counsel

- Either the Commission or EDFUND may meet in closed session to receive advice of their respective counsel on pending litigation. For purpose of the Act, litigation is "pending" in three basic situations. First, where either organization is a party to existing litigation. Second, where under existing facts and circumstances, either organization has substantial exposure to litigation. Third, where either organization is meeting for the purpose of determining whether to initiate litigation.

(Government Code section 11126, subdivision (e).)

Real Estate

- Either the Commission or EDFUND may meet in closed session to advise its negotiator in situations involving real estate transactions and in negotiations regarding price and terms of payment. However, before meeting in closed session, the respective organization must identify the specific parcel in question and the party with whom it is negotiating.

(Government Code section 11126, subdivision (c)(7).)

Security

- Either the Commission or EDFUND may, upon a two-thirds vote of those present, conduct a closed session to consider matters posing a potential threat of criminal or terrorist activity against the personnel, property, buildings, facilities, or equipment, including electronic data, owned, leased, or controlled by the body, where disclosure of these considerations could adversely affect their safety or security.

(Government Code section 11126, subdivision (c)(18).)

[2] Notwithstanding the Act, the EDFUND President and EDFUND employees are not public employees and, if not for the Act, issues of compensation brought to the EDFUND Board, if any, would be confidential and not subject to public disclosure. Nothing within the Act subjects the EDFUND Board to evaluate or discuss issues of compensation at a Board or committee meeting.

Meeting Notices

Meeting notices shall be given and made available on the Internet at least 10 days in advance of the meeting. Prior to holding any closed session, a meeting notice must indicate that a closed session will be held and must include a description of any item to be transacted or discussed in closed session. Meeting notices, for either open or closed sessions shall include a brief general description of an item (usually 20 words or less). In general, the items on the meeting notice should be written to provide interested lay persons with enough information to allow them to decide whether to attend the meeting or to participate in that particular agenda item. The description of an item to be transacted or discussed in closed session shall at a minimum include a citation of the specific statutory authority under which a closed session is being held.

A meeting occurs when a quorum of each respective organization convenes to address issues under the respective organization's jurisdiction.

(Government Code section 11125, 11122.5.)

Agendas

All agendas should follow the respective organization's standard meeting agenda format and should include a reference to any closed session. All agendas should be reviewed by the respective organization's legal counsel before each agenda is finalized and published.

A separate agenda shall be prepared for closed sessions clearly distinguishing items to be considered in closed session. The closed session agenda should cite the statutory authority or provision that authorized the particular closed session. Closed session agenda and any supporting materials shall be clearly marked CONFIDENTIAL and handled and secured in a manner that respects the nature of the material.

The Commission and EDFUND should each have their respective agendas and background materials for both open and closed sessions mailed or electronically transmitted to their members at least 10 days in advance of the meeting, unless the Chair of their respective body approves an alteration to such schedule.

Conducting Closed Session

A closed session shall be held only during a regular or special meeting of either the Commission or EDFUND. The respective organization's legal counsel should be present during all closed sessions, if possible. Prior to convening into closed session, the Chair of either the Commission or EDFUND must publicly announce that its organization is going into closed session and should state those issues that will be considered in closed session. In the closed session, each organization may consider only those matters covered in the meeting notice. After any closed session, each organization shall reconvene into open session prior to adjournment and shall disclose any reportable actions taken in closed session. Upon determination by either the Commission or EDFUND, the respective organization may record its closed session.

(Government Code section 11126.3.)

Minutes/Records

All matters discussed or disclosed during a lawfully held closed session and all notes, minutes, records or recordings made of such a closed session are confidential and shall remain confidential unless and until required to be disclosed by action of the respective organization or by law.

The Commission and EDFUND shall each designate an individual (such as legal counsel, a commissioner or board member and/or employee) to attend a closed session meeting and to document in a minute book a record of closed session topics discussed and any decisions made at the meeting. This minute book may, but need not, consist of a recording of the closed session.

The minute book is not a public record subject to inspection pursuant to the California Public Record Act (Government Code section 6250, Chapter 3.5 of Division 7 of Title 1), and therefore shall be kept confidential. The minute book shall be available to the respective members of each organization, including ex officio members, and the respective organization's legal counsel.

If a violation is alleged to have occurred at a closed session, a court of general jurisdiction may have access to the minute book. Minutes of a closed session shall be reviewed by legal counsel and reviewed and signed by the Chair of the respective organization that entered into the closed session.

(Government Code section 11126.1)

Best Practices

Nothing contained within this policy shall prevent either the Commission or EDFUND from adopting additional requirements that are not addressed in this policy, so long as these additional requirements are not inconsistent with this policy, the Act or any other relevant law or administrative decisions.

12.c

Action/Information Item

California Student Aid Commission

Consideration of the 2006-07 Loan Program Incentive Compensation 75% Methodology

The Bureau of State Audits (BSA) April 2006 report recommended that the Commission direct its executive director and EDFUND's president to resolve outstanding issues related to the methodology used to measure EDFUND's performance which affects the bonuses for its non-executive employees.

Prior to the Commission's approval of the 2006-07 Loan Program Business Plan and Budget in September 2006, Commission and EDFUND staffs had begun collaborative discussions to work out several issues stemming from the methodology and calculation formulas utilized in determining the EDFUND incentive compensation payments for 2006-07. In February 2007, the Executive Director informed the Commission Chair of the progress made in resolving these issues, noting that two issues remained unresolved. However, Commission and EDFUND staffs have now reached agreement on all issues except one.

Although both Commission and EDFUND staffs agreed that a minimum performance standard of 75% must be achieved in order to receive a bonus, neither staffs have reached agreement on how the 75% is calculated and applied. Tab 12.c.1 specifically identifies Commission staff's and EDFUND staff's recommendations on the calculation methodology.

Recommended Action: Make a final determination regarding the 75% calculation and application for the 2006-07 High Level Organizational Metrics.

Responsible Staff:

Diana Fuentes-Michel
Executive Director

Janet McDuffie
Chief, Management Services and Acting Chief, Federal Policy & Programs

Sam Kipp
EDFUND President

Martin Scanlon
EDFUND Vice President Finance & Administration and Chief Financial Officer

2006-07 LOAN PROGRAM INCENTIVE COMPENSATION 75% METHODOLOGY

BACKGROUND

CSAC staff maintains the philosophy that incentive compensation plans are intended to promote and reward achievement that exceeds established goals. CSAC staff expects that goals will be set to represent an improvement from the previous year. During the meetings between CSAC and EDFUND staffs, CSAC staff contended that if a goal is achieved a bonus is earned. Likewise, if a goal is not achieved then a bonus is not earned.

EDFUND staff argued that they should receive credit for coming close to achieving a goal regardless of whether the goal is achieved. In the spirit of compromise, CSAC staff agreed to use a 75% calculation with the understanding that this would be revisited after the first year to determine if the 75% is an effective measure. However, there has not been agreement on how the 75% is calculated and applied. Therefore, there has been no opportunity to determine if the 75% was an effective measurement.

CSAC STAFF'S RECOMMENDATION

CSAC staff recommends that a 75% minimum improvement level over the prior year performance must be achieved before a bonus is recognized. This can withstand public scrutiny and be easily explained and defended.
CSAC staff expects that goals will be set to represent an improvement from the previous year. [NOTE: The Commission approved the 2006-07 Loan Program Business Plan and Budget, which includes a set of goals that represent increases over the 2005-06 metrics.] To receive a bonus EDFUND must achieve 75% of the targeted improvement as illustrated in the table below in Metric 4. CSAC contends that in order to receive a bonus, 75% over the previous year's performance or 107.5 must be achieved before a bonus can be earned.

Each goal is weighted 20%.

	Actual 05-06	Goal 06-07	Actual 06-07	CSAC		EDFUND		CSAC Weighted Total	EDFUND Weighted Total
Metric 1	100	110	90	0%	No Bonus	0%	No Bonus	0	0
Metric 2	100	110	100	0%	No Bonus	75%	Bonus	0	15
Metric 3	100	110	101	0%	No Bonus	78%	Bonus	0	15.6
Metric 4	100	110	107.5	75%	Bonus	93%	Bonus	15	18.6
Metric 5	100	110	115	100%	Bonus	100%	Bonus	20	20
							Overall Total	**35**	**69.2**

EDFUND STAFF'S RECOMMENDATION

EDFUND assumes that the prior year achievement level equates to 75% of goal accomplishment and any incremental performance above the prior year would be above 75% and constitute an incentive compensation payment. EDFUND maintains that the change between each baseline amount and the associated 2006-07 goal represents 25% of total performance expectations in order to reach 100% achievement. Thus, EDFUND could make no improvement from the previous year as illustrated by Metric 2 and receive a 75% bonus.

CSAC staff consistently states that 75% of the increment or 107.5 must be achieved before a bonus can be recognized (Metric 4). Applying EDFUND'S calculation, if they achieved 107.5 they would earn a 93% bonus instead of the 75% as understood by CSAC staff.

This illustrates that an overall total score of 69.2 can be achieved when only one goal is met. By EDFUND assuming that the prior year achievement level is 75%, it is highly likely that EDFUND would achieve bonus level performance on all targets since just matching the prior year performance would result in a bonus.

12.d

Action/Information Item

California Student Aid Commission

Consideration of Policy on EDFUND Executive Compensation

The Bureau of State Audits (BSA) April 2006 report found that EDFUND's policy does not meet federal requirements for executive salary determination, nor does EDFUND adhere to all elements of its policy. BSA recommended that the Commission ensure that EDFUND complies fully with federal regulations and its policy governing salary setting for its executives, including modifying its policy to address Board Members who have a conflict of interest and ensuring that its consultants compile comparable compensation data solely from similar financial related organizations. The Commission process established in response to BSA's recommendation requires that the EDFUND Board seek advice of outside legal counsel on the adequacy of the compensation comparison methodology used by EDFUND in meeting federal requirements for nonprofit tax-exempt organizations.

The EDFUND Personnel and Nominations (PEN) Committee developed a draft Executive Compensation Policy, in consultation with Watson Wyatt, the consulting firm engaged to assist the EDFUND Board with the review of existing executive salary policy and process. The EDFUND PEN Committee also requested a legal opinion from the law firm of Foley & Lardner, LLP to be provided to the EDFUND Board prior to Board approval. Based upon the legal opinion, dated March 17, 2007, several minor changes were made to the draft policy, including the addition of an incentive compensation cap. A copy of the legal opinion is enclosed (Tab 12.d.2).

The EDFUND Board discussed the enclosed draft proposed policy (Tab 12.d.3) at its April 9, 2007 meeting. Commission (CSAC) staff raised a number of questions and concerns regarding the draft policy. While the EDFUND Board agreed to some revisions to the draft, CSAC staff has the following outstanding issues:

1. Precondition for Incentive Compensation

   During the April 9, 2007 EDFUND Board meeting, CSAC staff raised an issue regarding the precondition statement contained in the EDFUND Executive Compensation Policy. The policy currently states the following:

   > *"There is a requirement that a positive operating margin for the loan program be a threshold for payment of any award and be consistent with the CSAC Policy Statement and Guidelines on EDFUND Incentive Compensation Plans."* [Tab 12.d.3, page 2, Annual Incentive Plan (AIP), 3rd bullet]

   BSA recommended that the EDFUND Executive Management Team (EMT) should not receive a bonus if the Federal Family Education Loan (FFEL) Program or Operating Fund realizes a deficit. This precondition statement does meet a portion of the BSA recommendation. However, EDFUND staff has indicated that IRS guidelines specify that the person receiving incentive compensation for achieving a performance goal must have meaningful influence or control over the achievement of that goal. Therefore, EDFUND can only be held accountable for the FFEL Program operating surplus. CSAC staff concurs with

EDFUND's assessment and agrees that because the Operating Fund also funds non-loan program items, EDFUND cannot be held accountable for those budget items. However, the precondition included in the draft policy may not necessarily meet the Commission's expectations regarding the loan program surplus. When the Commission approves the budget, it approves a specific loan program operating surplus, also known as "Loan Program Revenues Net of Expenses." (See Tab 12.d.1 - chart, line 8) CSAC staff has recommended that the precondition statement be changed to reflect this expectation, as noted below:

> *"A precondition for incentive compensation requires that the year-end Loan Program Revenues Net of Expenses will be a surplus and no less than as approved by the Commission in the annual Loan Program Business Plan and Budget or any subsequent approved change to the budget."*

EDFUND staff expressed concerns with CSAC staff's recommendation and both staffs will meet to discuss further and present recommendations to the Commission at its April meeting.

2. <u>Conformity with Roles and Responsibilities</u>

   Throughout the current draft are references to the Commission Chair's responsibilities. CSAC staff reminded the EDFUND Board that the responsibilities of the Chair of the Commission are still being discussed as the Commission develops the roles and responsibilities. Once the roles and responsibilities are finalized, this policy as well as others will need to be reviewed to ensure that the Chair's and Commission's roles conform.

3. <u>Executive Compensation - Peer Group Data</u>

   Page 5 of the draft policy indicates that the EDFUND PEN Committee will use comparative data from peer groups in its analysis of the relevant market data for each position with the EMT.

   CSAC staff has concerns regarding the selection of the peer group and the limitation of the peer group to non-profit organizations. On November 17, 2006 and, again, on April 9, 2007, CSAC staff requested a copy of the Executive Level Assessment to better understand how the peer groups were selected and used in the determination of the appropriate market levels for comparison and to assess each incumbent executive accordingly. EDFUND staff provided a list of entities in the peer group on April 6, 2007; however, it did not address CSAC staff's specific request for the material from Watson Wyatt that explains how the consultant arrived at the peer group and other determinations. To date, this information has not been provided. At its April 9, 2007 meeting, the EDFUND Board discussed the issue raised by CSAC staff and decided not to make any changes to the policy as this policy falls under the responsibilities of the EDFUND Board.

CSAC staff is not in a position to either endorse or recommend changes to the policy without the information requested above. Upon receipt of the requested information, CSAC staff will work with EDFUND staff to develop a mutually agreed upon policy.

Responsible Staff:	Janet McDuffie Chief, Management Services and Acting Chief, Federal Policy & Programs	David Reid General Counsel & Vice President EDFUND Legal Services

CALIFORNIA STUDENT AID COMMISSION **Tab 12.d.1**
OPERATING FUND

		Annual Budget
	Loan Program	
	STANDARD ACTIVITY	
1	Standard revenues	xxx
2	Standard expenses	xxx
3	**STANDARD OPERATING REVENUES NET OF EXPENSES**	**xxx**
	SUPPLEMENTAL ACTIVITY	
	Revenues	
4	Supplemental revenues	xxx
5	Total supplemental revenues	xxx
	Expenses	
6	Supplemental expenses	xxx
7	Total supplemental expenses	xxx
8	**LOAN PROGRAM REVENUES NET OF EXPENSES**	**xxx**
	Non Loan Program	
	Expenses	
9	Commission activity	xxx
10	Public awareness campaign	xxx
11	Outreach campaign	xxx
12	Total non loan expenses	xxx
13	**OVERALL OPERATING REVENUES NET OF EXPENSES**	**xxx**

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CLIENT/MATTER NUMBER
077140-0106

March 17, 2007

The Board of Directors
EDFUND
3300 Zinfandel Drive
Rancho Cordova, California 95670

Re: Executive Compensation Policy

Ladies and Gentlemen:

You have asked for our opinion with respect to a proposed Executive Compensation Policy (the "EDFUND Policy") under review by the EDFUND Board, as well as a Policy Statement and Guidelines Memorandum adopted by the California Student Aid Commission ("CSAC"), entitled "EDFUND Incentive Compensation Plans" (the "CSAC Policy"). CSAC is considering revisions to the CSAC Policy and has asked the EDFUND Board to comment on the same.

This letter reflects our opinion whether the EDFUND Policy and the CSAC Policy are consistent with: (i) the requirements of the California Nonprofit Integrity Act; and (ii) the prohibitions against "private inurement," "private benefit" and "excess benefits" applicable to organizations exempt from tax pursuant to Section 501(c)(3) of the Internal Revenue Code ("IRC"). Except as specifically noted, we consider the EDFUND Policy and the CSAC Policy together as a unit (collectively, the "Policies").

Summary of Opinions

Based on our understanding of the facts and our analysis of the law, we are of the opinion that:

1. The Policies comply with the California Nonprofit Integrity Act.

2. The Policies are consistent with the "private inurement," "private benefit" and "excess benefits" doctrines.

   a. These doctrines require that executive compensation be reasonable in amount. It is our opinion that the procedures the Policies provide for are consistent with guidelines that have been developed under law and by the IRS for assuring the reasonableness of compensation. Moreover, it is our opinion that compensation established in accordance with the Policies will qualify for the "presumption of reasonableness" under IRC Section 4958.

b. The private inurement and private benefit doctrines, however, present requirements for incentive compensation arrangements in addition to reasonableness of amount. In our opinion, subject to the limitations noted below, the Policies are consistent with these additional requirements.

- An incentive compensation system may not: (i) have performance goals that improperly motivate conduct inconsistent with tax exempt purposes; and (ii) provide incentive compensation to a person based on the achievement of a performance goal unless that person has meaningful influence or control over the achievement of that goal. Here, no performance goals have yet been adopted under the Policies. However, the Policies contain guidelines for adoption of performance goals that would meet these requirements. Therefore, the Policies should be adequate, provided that their guidelines are followed.

- IRS guidelines require that incentive compensation arrangements have a "cap" to assure that they do not result in any unreasonable compensation "windfalls." As written, the Policies do not establish a cap, but do require a specific determination that each and every award of incentive compensation be reasonable in amount. We believe that this requirement serves as the functional equivalent of a cap. However, if the IRS were to examine the Policies, it would likely question the lack of a cap.

Analysis

1. *The California Nonprofit Integrity Act*

In relevant part, the California Nonprofit Integrity Act (the "Act") requires that the board of directors of a public benefit corporation, such as EDFUND, review and approve the compensation of its president or chief executive officer, as well as its treasurer or chief financial officer to assure that such compensation is "just and reasonable." California Government Code Section 12586(g).

The Policies cover the compensation of EDFUND's President and Vice Presidents, including, we understand, one Vice President who has the duties of a treasurer/CFO. Accordingly, the Policies cover the positions required by the Act.

However, the Policies provide that all awards of incentive compensation are subject to concurrence or modification by the CSAC Chair. Modification might include an increase, and the increased amount would not be compensation approved by the EDFUND board, as required by the Act. The EDFUND Policy provides that the CSAC Chair shall not increase the amount of a proposed award of compensation, but the EDFUND Policy does not bind the CSAC Chair. In order to better assure compliance with the Act, we recommend either that: (i) the CSAC board amend the CSAC Policy to provide that the CSAC Chair may only approve or decrease, but not increase, any proposed incentive compensation award; or (ii) the EDFUND board amend the EDFUND Policy to provide that the EFUND board shall review any increase approved by the CSAC Chair and shall pay the increase only if the EDFUND board determines that such increase is reasonable.

2. *Private Inurement, Private Benefit and Excess Benefits Rules.*

a. Reasonableness; Presumption of Reasonableness. While the private inurement, private benefit, and excess benefit doctrines differ from each other in various respects, they all prohibit organizations exempt from tax under IRC Section 501(c)(3) from excessively compensating their executive officers. An exempt organization that unreasonably compensates its executives jeopardizes its exempt status and exposes the unreasonably compensated executives, as well as the board members or others who approved the compensation, to monetary fines.

Courts and the IRS have begun to recognize certain "best practices" as a means to assure that executive compensation is reasonable. In promulgating regulations under IRC Section 4958 (which sets out the penalties for excess benefit transactions), the IRS has collected these best practices, and has provided that compensation approved in accordance with them is entitled to a "presumption of reasonableness." Obtaining a presumption of reasonableness is important. If the IRS decides to challenge the reasonableness of compensation approved in accordance with these practices, it will bear the burden of proving that the compensation is unreasonable. *See,* Treas. Reg. Section 53.4958-6. Otherwise, the taxpayer bears the burden of proof.

Three basic procedural requirements must be satisfied for compensation to qualify for the presumption of reasonableness:

- First, the compensation of the principal executive officers must be approved by the organization's board of directors (or a committee to which the board has delegated approval authority), and all members of the board (or committee) participating in the approval process must be free of all conflicts of interest, as defined in the regulations.

  As discussed above, the Policies address the "Board approval" requirement by stipulating that the EDFUND Board must approve all executive compensation. However, as noted above, to have greater confidence in the sufficiency of the Policies, either: (i) the CSAC Board should amend the CSAC Policy to prohibit the CSAC Chair from increasing any proposed incentive compensation; or (ii) the

EDFUND Board should amend the EDFUND Policy to provide that the EFUND board shall review any increased incentive approved by the CSAC Chair and shall pay the increase only if the EDFUND board determines that the increase is reasonable.

The EDFUND Policy also addresses the conflict of interest rule by providing that each member of the Board, Executive Committee and Personnel and Nominations ("PEN") Committee who participates in compensation discussions and decisions shall be free from all conflicts of interest. The EDFUND Policy adopts the definition of "conflicts of interest" that is used in the regulations under IRC Section 4958. Accordingly, the Policies satisfy the first procedural requirement.

- Second, the board (or committee), in considering the reasonableness of a proposed compensation arrangement, must have before it and rely on objective criteria that support the reasonableness of the proposed compensation amount.

  The EDFUND Policy does provide for the development of and reliance on objective criteria of reasonableness. Specifically, the EDFUND Policy directs the PEN Committee to obtain and review "comparable data from a select peer group of not-for-profit student loan operations with an emphasis on revenue, budget, complexity and mission." The EDFUND Policy further provides that the Executive Committee and the Board will both receive such data (or summaries of it), augment the data received as appropriate, and establish compensation based on the criteria so developed. Accordingly, the Policies satisfy the second procedural requirement.

- Third, minutes must be kept of each meeting at which compensation is considered or approved. The minutes must reflect: (i) the terms and conditions of the compensation arrangement at issue; (ii) the members of the board (or committee) who participated in the debate and/or approval of the arrangement and the vote taken; (iii) the objective criteria relied on and the rationale of the board (or committee) in determining that the objective criteria supported the reasonableness of the arrangement; and (iv) the identity of any member of the board (or committee) who had a conflict of interest that prevented participation in the process.

  The EDFUND Policy requires that each meeting of the Board, the Executive Committee and PEN Committee at which compensation is discussed or approved be documented by minutes reflecting the decisions made, members present, nature and source of data or other information considered, and rationale(s) for decisions made. However, the regulations require that the meeting minutes also reflect the identity of each person who voted on the matter. While this requirement is arguably present in the provisions of the EDFUND Policy requiring the minutes to reflect "the decisions made" and "members present," it would be better to specifically require that voting results be stated. In addition, the regulations require that minutes of a board (or committee) meeting must be prepared before the next meeting of the board (or committee) or, if later, 60 days after the meeting. This timing requirement should be added to the EDFUND Policy.

b. Additional Issues Relevant to Incentive Compensation. Incentive compensation arrangements raise issues under the "private inurement" and "private benefit" doctrines in addition to reasonableness. Such additional issues arise out of the case law, statutes and regulations, but have primarily been shaped by IRS interpretations. In its *Continuing Professional Education Technical Instruction Program for FY 2000*, the IRS reviewed and summarized this law in the context of incentive compensation arrangements for physicians. The principles discussed apply to any IRC Section 501(c)(3) organization. The IRS identified 13 relevant factors in its *Instruction Program*. However, these may be distilled into three broad principles:

- First, incentive compensation arrangements that motivate behavior that conflicts with the achievement of exempt purposes violate the proscription against private benefit. For example, incentive compensation arrangements that place undo focus on the bottom line may well result in decisions to cut back or reduce the delivery of exempt services, or to reduce operating expenses in ways that impair the quality of services provided, all in conflict with the achievement of broad public benefit. To avoid undo focus on the bottom line, the IRS requires that fiscal measures be accompanied in incentive compensation arrangements by other measures that reflect directly on the achievement of exempt purposes.

  Although specific incentive goals have not yet been adopted, both Policies provide for the adoption of performance goals that further EDFUND's exempt purposes.[1] Provided that the performance goals actually adopted measure not only financial performance but also quality measures, such as loan guarantee volume, market share, customer feedback, default rate, employee turnover rate, etc., this requirement will be satisfied.

- Second, an individual who stands to benefit from an award of incentive compensation based on the achievement of one or more performance goals must have some meaningful influence or control over their achievement. If the individual has such influence or control, then the incentive compensation may be justified as additional compensation paid for a job well done. If the individual lacks such influence or

[1] The CSAC Policy prescribes the adoption of goals "that support the organization's mission and strategic objectives," and that are "aligned with the goals of the organization." To cite a few examples, the EDFUND Policy similarly states a general purpose of establishing compensation programs that "reflect and perpetuate the mission of our organization," and that encourage "superior customer service," and the "continued maximization of benefits to the borrower."

control, then the payment lacks a service connection and assumes more of the feel of a profit distribution in violation of the private inurement doctrine.

The EDFUND Policy provides in this regard that "Participants should have authority, influence and/or control over individual goal achievement." Again, provided that the terms of the EDFUND Policy are observed in establishing specific incentive compensation goals, this principle should be satisfied.

- Third, because incentive compensation is inherently indefinite in amount at the time an incentive compensation arrangement is established, the IRS takes the position that incentive compensation arrangements should incorporate a "cap" or maximum amount as assurance that, regardless of what happens, there will be no unreasonable compensation windfalls.

  Here, the Policies do not contain a cap. Nonetheless, the Policies do require that a determination of reasonableness be made not only when a compensation package is adopted, but also when specific amounts of incentive compensation are determined. This "second look" at the actual amount of an incentive compensation award serves the same purpose as a cap – namely, assuring that an incentive formula does not result in any unanticipated and unreasonable compensation windfalls. Accordingly, we believe that this second look serves as an adequate substitute for a cap. Nonetheless, in the event of an examination, the IRS is likely to question the lack of a cap.

* * * * *

We are hopeful that this letter sufficiently responds to your request. In the event you would like us to address other issues, however, or if you would like to discuss any of the issues addressed herein in further detail, please do not hesitate to contact us.

This letter is solely for your benefit and may not be relied on by any other person without our prior written consent. This letter is based on the law as it exists on the date hereof. Such law is subject to change at any time, and any such change may materially affect the conclusions set forth above. We expressly disclaim any responsibility to update this letter in the event of any such changes in the law.

Very truly yours,

Mark T. Schieble

EDFUND

EXECUTIVE COMPENSATION POLICY

I. POLICY STATEMENT

EDFUND is a loan services auxiliary with a national presence and clientele, operating as the non-profit auxiliary of a State agency. EDFUND'S policy is to provide to its executives direct compensation programs and potential earnings opportunities that reflect and perpetuate the mission of the organization: ***maximizing benefits to borrowers by being the premier service provider in the student loan industry.*** To encourage superior customer service, profitable growth and operating performance, as well as continued maximization of benefits to borrowers, EDFUND'S pay and incentive programs will reward both individual and organization performance which emphasizes these goals and results. Programs are designed to:

- Attract, retain, and motivate highly qualified executives to achieve mission-critical outcomes.
- Provide overall compensation and benefit opportunities consistent with reasonable, market-based pay packages.
- Support the organization's mission and strategic objectives by aligning rewards with accomplishing those objectives;
- Provide appropriate rewards for superior organization and individual performance and skills.

To implement these policy guidelines, EDFUND generally recruits executive talent from both non-profit and for-profit financial services organizations.

This policy applies to the review, establishment and administration of all cash and non-cash compensation policies and programs and major changes in EDFUND'S benefit plans that are applicable to the President and the members of the Executive Management Team as well as any other individual or groups the Board of Directors deems appropriate, based upon its interpretation (as guided by EDFUND'S Legal Counsel) of the definition of "disqualified persons" in Section 4958 of the Internal Revenue Code of 1986. It is EDFUND'S intention to perform its duties in a manner that will establish a presumption that the total remuneration packages offered to the President, the Executive Management Team, and other "disqualified persons" are reasonable.

II. EXECUTIVE COMPENSATION PROGRAMS

Base Salary Program

The objective of the base salary program is to provide a market-based program for functionally comparable positions. EDFUND'S positioning for base salary will consider:

- Organizational need and the identification of exceptional talent in cases warranting above-market positioning;
- The individual's performance, skill set and experience as well as the position's relationship to market data;

- Possible adjustment annually and positioning within the reasonable market range;
- A range generally within ten percent of the median or 75th percentile ranges of comparable positions, adjusted to reflect scope, functionality and complexity.

Annual Incentive Plan (AIP)

The objective of the AIP is to reward the successful achievement of the organization's annual strategic business goals and to provide competitive variable compensation opportunities. The AIP should balance both financial and individual goals and:

- Participants should have authority, influence and/or control over individual goal achievement;
- Plan payments should be reasonable and commensurate with individual performance and company affordability and be aligned with comparable market opportunities;
- There is a requirement that a positive operating margin for the loan program be a threshold for payment of any award and be consistent with the CSAC Policy Statement and Guidelines on EDFUND Incentive Compensation Plans;
- The recommendation and payment of any annual incentive amount will consider both the organization's and the individual's performance and will be within a reasonable market range given the contribution of the individual and organizational results as well as the value of the total compensation package.
- The benchmark and cap on executive annual incentive compensation is set at twenty percent of annual base salary of the participants. In calculating the actual individual incentive compensation amounts:

  (A) Seventy-five percent (fifteen percent of annual base salary) shall be based on the company's overall performance score consistent with the goals adopted in the annual business plan, and
  (B) Twenty-five percent (five percent of annual base salary) shall be based on individual performance.

Benefit Plans

EDFUND'S Executive Benefit Plans will reflect what is typical practice among similar organizations and be targeted to provide market median levels of compensation. The objective of benefit plans is to assist in the long-term well being and retention of employees and includes:

- Health and Welfare plans which are provided to protect and care for employees and their families under certain circumstances;
- Executive Retirement plans (including qualified and supplemental plans) which provide a total retirement package to senior level executives that targets between the median and 75th percentiles of typical market practice, with an emphasis on long-term employment and wealth accumulation;
- Supplemental Benefits which will not be emphasized and will be provided only if prevalent and significant for attracting and retaining executive talent.
- Perquisites, per se, which will not be provided. An automobile allowance is provided to the President consistent with typical market practice.

- Other Policies, including relocation and severance if utilized, which will be targeted at market median.
- Relocation policies will be designed to provide reasonable short-term assistance to new or transferring employees relocating from one area to another, as a recruiting tool, consistent with competitive practice.
- Severance benefits will be considered on a case by case basis, given the facts and circumstances of an individual's role, performance and situation in accordance with the provisions of the EDFUND Severance Policy. Any variance from the company's severance policy must have advance written approval from the Board of Directors or a committee to whom the Board delegates this role.
- EDFUND does not provide loans to its executives.

Employment Contracts

Generally EDFUND does not utilize employment contracts for its executives. If deemed appropriate, EDFUND may negotiate employment contracts on an as-needed basis, approved by the Board of Directors and only at the most senior and/or critical levels of the organization. Terms in the contract will conform to, as much as practicable, EDFUND'S standard policies.

Impact of Section 4958 of the Internal Revenue Code

EDFUND, through its governing bodies (PEN Committee, Executive Committee and Board of Directors) shall make every effort to establish a presumption that the total remuneration packages provided to its President and Executive Management Team are reasonable, as such presumption is contemplated in Section 4958 of the Internal Revenue Code of 1986, as amended from time to time.

III. RESPONSIBLE BODIES

Three EDFUND bodies have responsibilities in carrying out EDFUND'S Executive Compensation Policy. In addition, the President's incentive compensation amount and the total incentive compensation pool amount for the Executive Management Team are referred to the Executive Director and Chair of the Student Aid Commission.

The **EDFUND PEN Committee** is responsible for assessing the market for reasonable, comparable and appropriate data with which to compare each executive's total compensation package. The EDFUND PEN Committee ***provides its assessment*** to the EDFUND Executive Committee.

The **EDFUND Executive Committee** reviews and considers the market assessment, along with related information on organizational and individual performance, and ***provides its recommendation*** as to pay actions and awards for each executive to the EDFUND Board of Directors. The EDFUND Executive Committee recommends executive pay actions and policies/programs, or changes thereof, with respect to any payment or program that impacts the executive compensation package for disqualified persons.

The **EDFUND Board of Directors** has the authority to ***approve*** the recommendations of any element, change or payment related to executive pay packages.

The **Commission Executive Director** has the responsibility of reporting to the Commission Chair his/her recommendation on the overall performance of EDFUND and the assessment of the individual performance of EDFUND'S President. Additionally, the Commission Executive Director will report his/her recommendation on the annual incentive compensation amount to be paid to the President and the total annual incentive compensation pool to be allocated among the Executive Management Team.

The **Commission Chair** is responsible for concurring with or modifying the overall performance of EDFUND and the incentive compensation amount approved by the EDFUND Board of Directors for the President as well as the total annual incentive compensation pool amount to be allocated among the Executive Management Team.

IV. INDEPENDENCE

All members of the EDFUND Board of Directors, EDFUND Executive Committee and EDFUND PEN Committee, as well as the Commission Executive Director and Chair shall be independent and have no conflicts of interest, as defined in Internal Revenue Code Section 4958. A member of the authorized body does not have a conflict of interest with respect to a compensation arrangement or property transfer only if the member:

(A) Is not a disqualified person participating in or economically benefiting from the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person, as described in section 4958(f)(4) or §53.4958-3(b)(1);
(B) Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement or property transfer;
(C) Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement or property transfer;
(D) Has no material financial interest affected by the compensation arrangement or property transfer; and
(E) Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member.

All independent members will complete a statement of independence at least annually, which will be reviewed by EDFUND'S Legal Counsel.

V. ROLES AND RESPONSIBILITIES

Each EDFUND entity will carry out this policy in the following manner:

A. EDFUND *PEN Committee*

To determine the relevant market data for each position within the Executive Management Team, the EDFUND PEN Committee obtains and reviews reliable and comparable data from a select peer group of not-for-profit student loan operations with an emphasis on revenue, budget, complexity and mission. EDFUND'S revenue and budget will approximate the median for the select group. The peer group data will be supplemented by published survey data from a recognized, independent source representing similarly-sized, not-for-profit and for-profit financial services organizations. EDFUND will assign a weighting to the different sources to reflect the appropriate market for talent for functionally comparable positions within the loan servicing industry as follows:

Peer Group	50%
Not-for-Profit Financial Services Organizations (survey)	25%
For-Profit Financial Services Organizations (survey)	25%

This weighting may be revised from time to time based on the determination of the PEN Committee. The rationale for any such revisions will be documented in the minutes of the PEN Committee's meetings.

To determine the appropriate market levels for comparison and to assess each incumbent executive accordingly, total compensation ranges will be created based on the appropriate market data sources for base salary, total cash compensation (base salary plus annual incentives), total retirement, supplemental benefits and perquisites and total compensation (combination of all elements). The incumbent's current compensation package will be presented for comparison purposes against these comparable ranges for both the median and 75^{th} percentiles of the comparable market data. A summary of the analysis will be provided to the EDFUND Executive Committee for each individual executive.

B. **EDFUND** *Executive Committee*

The EDFUND Executive Committee's responsibility is to review the market assessments provided by the PEN Committee along with additional input to create its recommendations for pay actions and policy/program changes. The Executive Committee will seek input from the President and other members of the Executive Management Team as appropriate when assessing pay data. In reviewing the comparable data, organizational performance against budgets and expectations, individual performance objectives or indicators, the financial position of EDFUND and any pertinent facts and circumstances will be considered. In making its recommendations, the Executive Committee will seek proposed changes, as well as performance and other criteria, from EDFUND'S President for each member of the Executive Management Team. The Executive Committee will refer to all applicable Policy statements for elements of total compensation, and will consider the value of the compensation package in its entirety against the comparable data. The Executive Committee will present its recommendation to the Board of Directors for each individual, with related rationale and supporting information.

When establishing annual incentives, the Executive Committee will work with the President and the Executive Management Team as needed to incorporate into the annual incentive program design the objectives and milestones associated with key strategic initiatives. Annually, the Executive Committee will review with the Board of Directors the goals and objectives proposed by the President for EDFUND and the individual objectives for each Executive Management Team member.

The Executive Committee will evaluate the President's performance and the performance of the Executive Management Team in light of the goals established before recommending to the Board of Directors the annual incentive award amount and/or other incentives or benefit. The Executive Committee's evaluation will consider the President's input and the performance of each executive against established quantitative metrics and qualitative assessments.

The Executive Committee is also responsible for developing this policy and reviewing it at least every three years, deciding upon any modifications it deems reasonable, competitive, and equitable, to ensure that the Policy supports the long-term interests of EDFUND and provides a competitive and performance-oriented compensation opportunity for executives managing the organization. The Executive Committee will propose to the Board of Directors any modifications to the philosophy or to the individual plans, programs or policies. The Executive Committee will fully, consistently and faithfully apply the policy in a manner that will establish the presumption that total compensation decisions are reasonable under the provisions of Internal Revenue Code Section 4958 or Intermediate Sanctions.

C. **EDFUND** *Board of Directors*

The Board of Directors will review the evaluation, appropriate comparable data and recommendations of the Executive Committee before finalizing any salary, annual incentive award and/or other incentives or benefits decisions for the members of the Executive Management Team. The EDFUND Board of Directors is responsible for approving any cash or non-cash form of executive compensation and benefits as well as each payment accrued or paid. The Board of Directors will fully, consistently and faithfully apply the policy in a manner that will establish the presumption that total compensation decisions are reasonable under the provisions of Internal Revenue Code Section 4958 or Intermediate Sanctions.

The EDFUND Board of Directors will provide the Executive Director and the Chair of the Student Aid Commission with documentation that details the overall performance of EDFUND and an assessment of the individual performance of EDFUND's President. The EDFUND Board will also recommend to the Executive Director and the Chair of the Student Aid Commission the proposed incentive amount for the President and the total incentive compensation pool amount for the Executive Management Team.

D. Commission Executive Director

The Commission Executive Director will review the documentation that details the overall performance of EDFUND, as well as review the assessment of individual performance of the President provided by the EDFUND Board of Directors. The Executive Director will provide his/her recommendation to the Commission Chair as to the annual incentive amount for the President and the total annual incentive pool amount for the Executive Management Team.

E. Commission Chair

The Commission Chair will evaluate the EDFUND Board of Directors' report and the Commission Executive Director's report on the performance of the organization, and the President's individual performance, the annual incentive amount for the President and the total incentive pool amount for the Executive Management Team, and ratify or authorize a modified amount, with rationale for any adjustments. The Commission Chair's decision will be reported to the EDFUND Board of Directors. Any modification that increases incentive compensation amounts shall be returned to the EDFUND Board for determination of reasonableness.

VI. RECORDS AND SUPPORT

Each Committee and the Board of Directors will review, discuss and deliberate the matters under their purview and prepare minutes of each meeting in which executive compensation is discussed. The minutes will reflect the decisions made, members present, nature and source of data or information considered, any explanation or rationale for each decision for each executive, the identity of each person voting on the matter, and the voting results. Preparation of the minutes should be completed prior to the next Board or Committee meeting, but in no event later than sixty (60) days after such Board or Committee meeting.

The EDFUND PEN Committee, EDFUND Executive Committee and the EDFUND Board of Directors shall retain the right to consult and may engage the professional services of independent legal counsel, compensation experts, accountants and other experts and external advisors on matters related to executive compensation policies, practices and market data.

12.e

Action/Information Item

California Student Aid Commission

Consideration of Policy on EDFUND Incentive Compensation

The Bureau of State Audits (BSA) April 2006 report found that the Commission's Policy "EDFUND Incentive Compensation Plans" is flawed. The current policy allows EDFUND's Executive Management Team (EMT) to receive substantial bonuses even with an operating deficit and specifically excludes certain loan program revenues and expenses. BSA recommended that the Commission do the following:

1. Ensure that EDFUND determines bonuses for its president in accordance with Commission policy;
2. Modify its policy to ensure that EDFUND's EMT does not receive a bonus if the Federal Family Education Loan (FFEL) Program or Operating Fund realizes a deficit; and
3. Ensure that EDFUND includes all FFEL Program revenues and expenses in its calculation of the program's operating surplus or deficit.

The Commission process established in response to BSA's recommendations provided that the Commission would ask the EDFUND Board to review, with its management, all aspects of the incentive compensation policy approved by the Commission in August 2002, and propose appropriate adjustments to the Commission's Personnel, Evaluations & Nominations Committee and the Commission for their review and approval.

The EDFUND Personnel and Nominations (PEN) Committee developed a draft revised Commission Policy on EDFUND Incentive Compensation, in consultation with Watson Wyatt, the consulting firm engaged to assist the EDFUND Board with the review of existing executive salary policy and process. The EDFUND PEN Committee also requested a legal opinion from the law firm of Foley & Lardner, LLP to be provided to the EDFUND Board prior to Board approval. Based upon the legal opinion, dated March 17, 2007, several minor changes were made to the draft policy, including the addition of an incentive compensation cap. Refer to Tab 12.d.2 for a copy of the legal opinion.

The EDFUND Board discussed the enclosed "EDFUND Draft Revision" of the Commission Policy on EDFUND Incentive Compensation at its April 9, 2007 meeting. Commission (CSAC) staff raised a number of questions and concerns regarding the draft policy. While the EDFUND Board agreed to some revisions to the draft, CSAC staff has the following outstanding issues:

1. <u>Precondition for Incentive Compensation</u>

   During the April 9, 2007 EDFUND Board meeting, CSAC staff raised an issue regarding the precondition statement contained in the EDFUND Executive Compensation Policy. The policy currently states the following:

"A precondition for incentive compensation will require that a year-end net operating surplus for the loan program be a threshold for incentive compensation payment, excluding any non-loan program expenditures." [Tab 12.e.1, page 3, 1st paragraph]

BSA recommended that the EDFUND EMT should not receive a bonus if the Federal Family Education Loan (FFEL) Program or Operating Fund realizes a deficit. This precondition statement does meet a portion of the BSA recommendation. However, EDFUND staff has indicated that IRS guidelines specify that the person receiving incentive compensation for achieving a performance goal must have meaningful influence or control over the achievement of that goal. Therefore, EDFUND can only be held accountable for the FFEL Program operating surplus. CSAC staff concurs with EDFUND's assessment and agrees that because the Operating Fund also funds non-loan program items, EDFUND cannot be held accountable for those budget items. However, the precondition included in the draft policy may not necessarily meet the Commission's expectations regarding the loan program surplus. When the Commission approves the budget, it approves a specific loan program operating surplus, also known as "Loan Program Revenues Net of Expenses." (See Tab 12.d.1 - chart, line 8) CSAC staff has recommended that the precondition statement be changed to reflect this expectation, as noted below:

"A precondition for incentive compensation requires that the year-end Loan Program Revenues Net of Expenses will be a surplus and no less than as approved by the Commission in the annual Loan Program Business Plan and Budget or any subsequent approved change to the budget."

EDFUND staff expressed concerns with CSAC staff's recommendation and both staffs will meet to discuss further and present recommendations to the Commission at its April meeting.

2. <u>Conformity with Roles and Responsibilities</u>

Throughout the current draft are references to the Commission Chair's responsibilities. CSAC staff reminded the EDFUND Board that the responsibilities of the Chair of the Commission are still being discussed as the Commission develops the roles and responsibilities. Once the roles and responsibilities are finalized, this policy as well as others will need to be reviewed to ensure that the Chair's and Commission's roles conform.

The EDFUND Board discussed the issues raised by CSAC staff and decided not to make the above changes to the policy as this policy falls under the responsibilities of the EDFUND Board.

CSAC staff does not support the EDFUND Board's recommendation as it does not address the above issues. As mentioned above, CSAC staff plans and will attempt to meet with EDFUND staff to discuss and present recommendations to the Commission at its April meeting. Enclosed for your review is a red-lined version (Tab 12.e.1) of the EDFUND Draft Revision indicating the changes made to the current Commission policy, a clean version of the EDFUND Draft Revision (Tab 12.e.2), and a copy of the current policy (Tab 12.e.3).

Responsible Staff: Janet McDuffie
Chief, Management Services and
Acting Chief, Federal Policy & Programs

David Reid
General Counsel and
Vice President
EDFUND Legal Services

Tab 12.e.1
EDFUND DRAFT REVISION
RED-LINED VERSION

CSAC

POLICY STATEMENT AND GUIDELINES MEMO

SUBJECT: **EDFUND Incentive Compensation Plans**		CONTROL NUMBER
		EFFECTIVE DATE ~~August 12, 2002~~
APPROVED BY:	APPROVED BY:	EXPIRES:

Introduction

Pursuant to California Education Code Sections 69522 et seq., the California Student Aid Commission (the Commission) formed EDFUND as an auxiliary organization to perform operational and support services essential to the administration of the Federal Family Education Loan ~~FFEL~~ Program. It is the Commission's intention that EDFUND function as a performance based organization. EDFUND offers its employees incentive compensation plans in furtherance of this intent. The EDFUND Board of Directors has been designated as responsible to the Commission for the establishment of EDFUND's incentive compensation plans. This memorandum provides the Commission's guidelines for EDFUND's Incentive Compensation Plans.

COMMISSION'S INCENTIVE COMPENSATION PHILOSOPHY

The Commission's incentive compensation philosophy for EDFUND is based on the following principles:

- The combination of EDFUND's ~~basic~~ base pay and incentive compensation should be consistent with reasonable, competitive compensation ~~take into consideration the~~ practices of similarly situated organizations ~~and reflect the actual worth of work done by employees of the organization~~.
- The provision of incentive compensation must reflect the prudent use of funds provided to EDFUND for its administration and operation of the Federal Family Education Loan Program.
- Incentive compensation should promote and reflect organizational and individual performance and accountability by setting challenging, yet achievable~~,~~ goals that support the organization's mission and strategic objectives.
- Incentive compensation should help to attract, retain and motivate employees.

~~The EDFUND Board of Directors has been designated as responsible to the Student Aid Commission for the establishment of EDFUND'S incentive compensation plans.~~

INCENTIVE COMPENSATION PLAN ADMINISTRATION

EDFUND is responsible for developing corporate policies and procedures that address plan eligibility; plan design; organizational, departmental and individual performance goals and objectives; goals measurement; review and evaluation; approval processes; and the funding and distribution mechanism. The goals, at a minimum, should be specific, measurable, achievable, relevant, and timely. Departmental and individual goals should be aligned with the goals of the organization.

NON-EXECUTIVE INCENTIVE COMPENSATION PLANS

~~**Variable Pay Plans**~~
A. Number of Plans

There are three non-executive incentive compensation~~The following variable pay~~ plans that have been agreed to by the EDFUND Board and the Commission. These plans allow EDFUND to offer incentive compensation to designated employees:

- EDSHARE Variable Pay Plan for all employees except Client Relations Managers and Internal Collection Staff: This plan awards incentive compensation based on two components - - a company performance component and an individual performance component.

- EDSHARE Incentive Pay Plan for Client Relations Managers: This plan awards incentive compensation based on two components - - a company performance component and an individual loan volume performance component.

- ~~EDSHARE~~COLLECTION COMMISSION ~~Variable Pay~~ Plan for ~~Internal Collectors and~~ Internal Collection ~~Supervisors~~Staff: This plan awards incentive compensation based on performance against established collection net revenue targets.

- ~~EDSHARE Variable Pay Plan for all other employees other than EDFUND's Executive Management.~~

~~For each of these agreed upon variable pay plans, EDFUND is responsible for developing corporate policies and procedures that address plan eligibility, plan design, organizational, departmental and individual performance goals and objectives, goals measurement, review and evaluation, approval processes, and the funding and distribution mechanism. The goals, at a minimum, should be specific, measurable, achievable, relevant, and timely. Departmental and individual goals should be aligned with the goals of the organization.~~

The EDFUND Board of Directors and the Commission's Executive Director are responsible for approving ~~these initial plans~~incentive compensation plans and any subsequent changes to the ~~variable pay~~ plans. Each plan contains a specified cap. ~~Variable pay~~Incentive compensation plans that are specified in the ~~o~~Operating ~~a~~Agreement will be reflected in the EDFUND budget as a part of total wages and salaries.

B. Company Performance Component of EDSHARE Plans

~~The variable pay plan structure provides EDFUND participants the opportunity to receive incentive pay based upon the achievement of individual and/or corporate objectives. With respect to the attainment of corporate goals and objectives, a~~

At fiscal year end, the Commission~~'s Executive Director~~ will assess the percentage of accomplishment EDFUND has achieved toward the ~~"California Student Aid Commission's Performance Goals for EDFUND" as~~ high-level organizational goals as contained in the

Loan Program Business Plan that is approved by the EDFUND Board and the Commission in accordance with the provision ~~pursuant to Exhibit C~~ of the Operating Agreement. The company performance measure is an element in the formula to determine payments to employees qualifying for the EDSHARE plans.

C. Approval Process

1. At fiscal year end, the EDFUND Board recommends to the Executive Director and to the Commission Chair the percentage of company goals accomplished.
2. The Executive Director ~~will~~ reports his/her ~~findings~~ recommendation to the Commission Chair who ~~will~~ either concurs or modif~~y~~ies that recommendation on behalf of the Commission.
3. Once the decision on company performance percentage is made, the Commission Chair communicates this percentage to the EDFUND Board.
4. If either the Executive Director or the ~~President of~~ EDFUND Board disagrees with the decision rendered by the Commission Chair, one or both may request a review by the Commission. This review would be performed at the next scheduled meeting of the Commission. ~~A vote of the majority~~The decision of the Commission ~~will be the~~is final ~~decision on this matter~~. ~~Once the decision on Company performance is made, the Executive Director will communicate this percentage of performance to EDFUND and EDFUND will, given that percentage, prepare a summary of the total payment to be made under the variable pay plans for the Executive Director's review. The Commission's Executive Director will approve in writing the payments for reimbursement from the Operating Fund.~~
5. All activities associated with this process should be completed so as to ensure payment within seventy-five (75) days of the end of EDFUND's fiscal year.

DISCRETIONARY EXECUTIVE INCENTIVE COMPENSATION

EDFUND's executive management team, consisting of its President and Vice Presidents, may receive incentive compensation under the terms of this policy. A precondition for ~~this~~ incentive compensation ~~is that the loan program has been managed to~~ will require that a year end net operating surplus ~~or deficit at least as positive as the budget (as revised) for the year~~ for the loan program be a threshold for incentive compensation payment, excluding ~~the revenue and expenditures related to the Voluntary Flexible Agreement and~~ any non-loan program expenditures ~~directed by the Commission~~.

The Commission places responsibility to ~~propose~~ determine the amounts of Executive Incentive Compensation payment with the EDFUND Board or its designated committee, subject to the steps specified in numbers 4 and 5 below. The EDFUND Board shall make every effort to establish a presumption that the incentive compensation payment provided to its President and Vice Presidents is reasonable, as such presumption is contemplated in Section 4958 of the Internal Revenue Code of 1986, as amended. The Executive Compensation Plan contains a specified cap.

Approval Process

1. At ~~the~~ fiscal year end, the EDFUND Board ~~will~~ provides the ~~Commission's~~ Executive Director and the Commission Chair with documentation that details the overall performance of EDFUND and an assessment of the individual performance of ~~the corporation~~EDFUND's President. ~~This documentation should include the Board's assessment of the percentage of~~

~~accomplishment EDFUND has achieved toward the "California Student Aid Commission's Performance Goals for EDFUND" as contained in the Business Plan pursuant to Exhibit C of the Operating Agreement if the Board's performance assessment is different from the Executive Director's assessment prepared for the Variable Pay Plans.~~

2. The EDFUND Board ~~shall~~ also recommends to the Executive Director and to the Commission Chair the proposed incentive compensation amount~~, if any,~~ for the President and the total incentive compensation pool amount for the Executive Management Team.
3. The Executive Director ~~shall review and make~~ reports his/her recommendation on the performance assessment and the proposed incentive compensation amounts for the President and the total incentive compensation pool amount for Executive Management Team ~~and forward the entire matter~~ to the Commission Chair ~~of the Commission~~.
4. The Commission Chair ~~of the Commission will~~ evaluates the Board's report and the Executive Director's report~~s~~ and ~~will~~ determines whether or not the Incentive Compensation amounts ~~which are~~ proposed by the EDFUND Board are appropriate.
5. The Commission Chair ~~of the Commission will then determine what, if any,~~ either concurs or modifies the incentive compensation amounts ~~for the President and the Executive Management Team will be~~ and communicates his/her decision to the EDFUND Board. Any modification that increases incentive compensation amounts shall be returned to the EDFUND Board for determination of reasonableness.
6. If either the Executive Director~~Board~~ or the ~~Executive Director~~ EDFUND Board ~~does not~~ disagrees with the decision rendered by ~~of~~ the Commission Chair ~~of the Commission~~, ~~they~~ one or both may request a closed session review by the ~~full~~ Commission. This review would be performed ~~which will be held~~ at the next scheduled meeting of the Commission. The decision of the Commission ~~will be~~ is final.
7. ~~While the Executive Director and the Commission Chair shall each have five (5) working days for their respective actions, a~~All activities associated with this process should be completed so as to ensure payment within seventy-five (75) days of the end of EDFUND's fiscal year.

~~High Level Executive Incentive Compensation Process Flow and Tasks~~

~~EDFUND Executives~~ → ~~EDFUND Board~~ → ~~Commission Executive Director~~ → ~~Commission Chair~~ → ~~Full Commission (if required)~~

~~EDFUND Executives~~

~~Perform executive evaluations.~~

~~Perform and prepare assessment of the performance of EDFUND.~~

~~EDFUND Board~~

~~Evaluate information Submitted by the President~~

~~Propose incentive compensation for executives and submit to Commission's Executive Director, along with supporting documentation~~.

~~Commission Executive Director~~

~~Perform and prepare assessment of the overall Performance of EDFUND.~~

~~Review documentation and recommendation of the Board.~~

~~Make formal recommendations And forward all materials to Commission Chair.~~

~~Commission Chair~~

~~Review documentation received from the EDFUND Board and The Commission's Executive Director.~~

~~Approve President's Incentive Compensation and final total amount of payout for EDFUND executives.~~

~~Full Commission (if required)~~

~~Review and, if warranted, adjust Commission Chair's final position.~~

Tab 12.e.2
EDFUND DRAFT REVISION

CSAC POLICY STATEMENT AND GUIDELINES MEMORANDUM		CONTROL NUMBER
SUBJECT: **EDFUND Incentive Compensation Plans**		EFFECTIVE DATE
APPROVED BY:	APPROVED BY:	EXPIRES:

INTRODUCTION

Pursuant to California Education Code Sections 69522 et seq., the California Student Aid Commission (the Commission) formed EDFUND as an auxiliary organization to perform operational and support services essential to the administration of the Federal Family Education Loan Program. It is the Commission's intention that EDFUND function as a performance based organization. EDFUND offers its employees incentive compensation plans in furtherance of this intent. The EDFUND Board of Directors has been designated as responsible to the Commission for the establishment of EDFUND'S incentive compensation plans. This memorandum provides the Commission's guidelines for EDFUND'S Incentive Compensation Plans.

COMMISSION'S INCENTIVE COMPENSATION PHILOSOPHY

The Commission's incentive compensation philosophy for EDFUND is based on the following principles:

- The combination of EDFUND'S base pay and incentive compensation should be consistent with reasonable, competitive compensation practices of similarly situated organizations.

- The provision of incentive compensation must reflect the prudent use of funds provided to EDFUND for its administration and operation of the Federal Family Education Loan Program.

- Incentive compensation should promote and reflect organizational and individual performance and accountability by setting challenging, yet achievable goals that support the organization's mission and strategic objectives.

- Incentive compensation should help to attract, retain and motivate employees.

INCENTIVE COMPENSATION PLAN ADMINISTRATION

EDFUND is responsible for developing corporate policies and procedures that address plan eligibility; plan design; organizational, departmental and individual performance goals and objectives; goals measurement; review and evaluation; approval processes; and the funding and distribution mechanism. The goals, at a minimum, should be specific, measurable, achievable, relevant, and timely. Departmental and individual goals should be aligned with the goals of the organization.

NON-EXECUTIVE INCENTIVE COMPENSATION PLANS

A. Number of Plans

There are three non-executive incentive compensation plans that have been agreed to by the EDFUND Board and the Commission. These plans allow EDFUND to offer incentive compensation to designated employees:

- EDSHARE Variable Pay Plan for all employees except Client Relations Managers and Internal Collection Staff: This plan awards incentive compensation based on two components--a company performance component and an individual performance component.

- EDSHARE Incentive Pay Plan for Client Relations Managers: This plan awards incentive compensation based on two components--a company performance component and an individual loan volume performance component.

- COLLECTION COMMISSION Plan for Internal Collection Staff: This plan awards incentive compensation based on performance against established collection net revenue targets.

The EDFUND Board of Directors and the Commission's Executive Director are responsible for approving incentive compensation plans and any subsequent changes to the plans. Each plan contains a specified cap. Incentive compensation plans that are specified in the Operating Agreement will be reflected in the EDFUND budget as a part of total wages and salaries.

B. Company Performance Component of EDSHARE Plans

At fiscal year end, the Commission will assess the percentage of accomplishment EDFUND has achieved toward the high-level organizational goals as contained in the Loan Program Business Plan that is approved by the EDFUND Board and the Commission in accordance with the provision of the Operating Agreement. The company performance measure is an element in the formula to determine payments to employees qualifying for the EDSHARE plans.

C. Approval Process

1. At fiscal year end, the EDFUND Board recommends to the Executive Director and to the Commission Chair the percentage of company goals accomplished.
2. The Executive Director reports his/her recommendation to the Commission Chair who either concurs or modifies that recommendation on behalf of the Commission.
3. Once the decision on company performance percentage is made, the Commission Chair communicates this percentage to the EDFUND Board.
4. If either the Executive Director or the EDFUND Board disagrees with the decision rendered by the Commission Chair, one or both may request a review by the Commission. This review would be performed at the next scheduled meeting of the Commission. The decision of the Commission is final.
5. All activities associated with this process should be completed so as to ensure payment within seventy-five (75) days of the end of EDFUND's fiscal year.

DISCRETIONARY EXECUTIVE INCENTIVE COMPENSATION

EDFUND'S Executive Management Team, consisting of its President and Vice Presidents, may receive incentive compensation under the terms of this policy. A precondition for incentive compensation will require that a year end net operating surplus for the loan program be a threshold for incentive compensation payment, excluding any non-loan program expenditures.

The Commission places responsibility to determine the amounts of executive incentive compensation payment with the EDFUND Board or its designated committee, subject to the steps specified in numbers 4 and 5 below. The EDFUND Board shall make every effort to establish a presumption that the incentive compensation payment provided to its President and Vice Presidents is reasonable, as such presumption is contemplated in Section 4958 of the Internal Revenue Code of 1986, as amended. The Executive Compensation Plan contains a specified cap.

Approval Process

1. At fiscal year end, the EDFUND Board provides the Executive Director and the Commission Chair with documentation that details the overall performance of EDFUND and an assessment of the individual performance of EDFUND'S President.
2. The EDFUND Board also recommends to the Executive Director and to the Commission Chair the proposed incentive compensation amount for the President and the total incentive compensation pool amount for the Executive Management Team.
3. The Executive Director reports his/her recommendation on the performance assessment and the proposed incentive compensation amounts for the President and the total incentive compensation pool amount for Executive Management Team to the Commission Chair.
4. The Commission Chair evaluates the Board's report and the Executive Director's report and determines whether or not the incentive compensation amounts proposed by the EDFUND Board are appropriate.
5. The Commission Chair either concurs or modifies the incentive compensation amounts and communicates his/her decision to the EDFUND Board. Any modification that increases incentive compensation amounts shall be returned to the EDFUND Board for determination of reasonableness.
6. If either the Executive Director or the EDFUND Board disagrees with the decision rendered by the Commission Chair, one or both may request a closed session review by the Commission. This review would be performed at the next scheduled meeting of the Commission. The decision of the Commission is final.
7. All activities associated with this process should be completed so as to ensure payment within seventy-five (75) days of the end of EDFUND'S fiscal year.

CSAC **POLICY STATEMENT AND GUIDELINES MEMO**		CONTROL NUMBER
SUBJECT: **EDFUND Incentive Compensation Plans**		EFFECTIVE DATE August 12, 2002
APPROVED BY:	APPROVED BY:	EXPIRES:

Introduction

Pursuant to California Education Code Sections 69522 et seq., the Commission formed EDFUND as an auxiliary organization to perform operational and support services essential to the administration of the FFEL Program. It is the Commission's intention that EDFUND function as a performance based organization. EDFUND offers its employees incentive compensation plans in furtherance of this intent. This memo provides the Commission's guidelines for EDFUND's Incentive Compensation Plans.

The Commission's incentive compensation philosophy is based on the following principles:

- The combination of EDFUND's basic and incentive compensation should take into consideration the practices of similar organizations and reflect the actual worth of work done by employees of the organization.

- The provision of incentive compensation must reflect the prudent use of funds provided to EDFUND for its administration and operation of the Federal Family Education Loan Program.

- Incentive compensation should promote organizational and individual performance and accountability by setting challenging, yet achievable, goals.

- Incentive compensation should help to attract, retain and motivate employees.

The EDFUND Board of Directors has been designated as responsible to the Student Aid Commission for the establishment of EDFUND's incentive compensation plans.

Variable Pay Plans
The following variable pay plans have been agreed to by EDFUND and the Commission. These plans allow EDFUND to offer incentive compensation to designated employees:

- EDSHARE Incentive Pay Plan for Client Relations Managers.

- EDSHARE COLLECT Variable Pay Plan for Internal Collectors and Internal Collection Supervisors.

- EDSHARE Variable Pay Plan for all other employees other than EDFUND's Executive Management.

For each of these agreed upon variable pay plans, EDFUND is responsible for developing corporate policies and procedures that address plan eligibility, plan design, organizational, departmental and individual performance goals and objectives, goals measurement, review and evaluation, approval processes, and the funding and distribution mechanism. The goals, at a minimum, should be specific, measurable, achievable, relevant, and timely. Departmental and individual goals should be aligned with the goals of the organization.

The EDFUND Board of Directors and the Commission's Executive Director are responsible for approving these initial plans and any subsequent changes to the variable pay plans. Variable pay plans that are specified in the operating agreement will be reflected in the EDFUND budget as a part of total wages and salaries.

The variable pay plan structure provides EDFUND participants the opportunity to receive incentive pay based upon the achievement of individual and/or corporate objectives. With respect to the attainment of corporate goals and objectives, at fiscal year end, the Commission's Executive Director will assess the percentage of accomplishment EDFUND has achieved toward the "California Student Aid Commission's Performance Goals for EDFUND as contained in the Business Plan pursuant to Exhibit C of the Operating Agreement. The Executive Director will report his/her findings to the Commission Chair who will either concur or modify that recommendation on behalf of the Commission. If either the Executive Director or the President of EDFUND disagree with the decision rendered by the Commission Chair, one or both may request a review by the Commission. This review would be performed at the next scheduled meeting of the Commission. A vote of the majority of the Commission will be the final decision on this matter. Once the decision on Company performance is made, the Executive Director will communicate this percentage of performance to EDFUND and EDFUND will, given that percentage, prepare a summary of the total payment to be made under the variable pay plans for the Executive Director's review. The Commission's Executive Director will approve in writing the payments for reimbursement from the Operating Fund.

Discretionary Executive Incentive Compensation

EDFUND's executive management team, consisting of its President and Vice Presidents, may receive incentive compensation under the terms of this policy. A precondition for this compensation is that the loan program has been managed to a year end operating surplus or deficit at least as positive as the budget (as revised) for the year, excluding the revenue and expenditures related to the Voluntary Flexible Agreement and any non-loan program expenditures directed by the Commission.

The Commission places responsibility to propose the amounts of Executive Incentive Compensation payment with the EDFUND Board or its designated committee.

At the fiscal year end, the EDFUND Board will provide the Commission's Executive Director with documentation that details the overall performance of EDFUND and an assessment of the individual performance of the corporation's President. This documentation should include the Board's assessment of the percentage of accomplishment EDFUND has achieved toward the "California Student Aid Commission's Performance Goals for EDFUND" as contained in the Business Plan pursuant to Exhibit C of the Operating Agreement if the Board's performance assessment is different from the Executive Director's assessment prepared for the Variable Pay Plans. The Board shall also recommend the proposed incentive compensation amount, if any, for the President and the total incentive compensation amount for the Executive Management Team. The Executive Director shall review and make his/her recommendation on the performance assessment and the proposed incentive compensation amounts for the President and the Executive Management Team and forward the entire matter to the Chair of the Commission.

The Chair of the Commission will evaluate the Board's and the Executive Director's reports and will determine whether or not the Incentive Compensation amounts which are proposed by the EDFUND Board are appropriate. The Chair of the Commission will then determine what, if any, the incentive compensation amounts for the President and the Executive Management Team will be. If either the Board or the Executive Director does not agree with the decision of the Chair of the Commission, they may request a closed session review by the full Commission which will be held at the next scheduled meeting of the Commission. The decision of the Commission will be final. While the Executive Director and the Commission Chair shall each have five (5) working days for their respective actions, all activities associated with this process should be completed so as to ensure payment within seventy-five (75) days of the end of EDFUND's fiscal year.

High Level Executive Incentive Compensation Process Flow and Tasks

EDFUND Executives	EDFUND Board	Commission Executive Director	Commission Chair	Full Commission (if required)
Perform executive evaluations. Perform and prepare assessment of the performance of EDFUND.	Evaluate information Submitted by the President Propose incentive compensation for executives and submit to Commission's Executive Director, along with supporting documentation.	Perform and prepare assessment of the overall Performance of EDFUND. Review documentation and recommendation of the Board. Make formal recommendations And forward all materials to Commission Chair.	Review documentation received from the EDFUND Board and The Commission's Executive Director. Approve President's Incentive Compensation and final total amount of payout for EDFUND executives.	Review and, if warranted, adjust Commission Chair's final position.

12.f

Action/Information Item

California Student Aid Commission

Update and Consideration of Authority to Proceed with Hiring a Chief Internal Auditor

The Bureau of State Audits (BSA) recommended in its April 2006 report that the Commission replace its current chief of internal audits with an individual who is free from the appearance of organizational and personal impairments to independence. In June 22-23, 2006, the Commission approved the separation of the internal audit function between the Commission and EDFUND and the hiring of a new internal auditor for the Commission.

Commission staff received approval from the Department of Personnel Administration (DPA) to use the Senior Management Auditor classification for the new Chief Audit Executive position. However, at the February 22-23, 2007 Commission meeting, Commissioner Johnston raised several concerns regarding the hiring of the Chief Audit Executive.

On April 5, 2007, the Executive Director sent the enclosed letter to the Commissioners addressing each of the concerns raised by Commissioner Johnston. As noted in the letter, Commission staff recommends that the Commission authorize the hiring of the Chief Audit Executive with responsibility for all of the Commission's programs, including the loan program, as approved by DPA.

Recommended Action: Authorize staff to proceed with the hiring of a Chief Audit Executive.

Responsible Staff: Janet McDuffie
Chief, Management Services and Acting Chief, Federal Policy & Programs

CALIFORNIA STUDENT AID COMMISSION

Office of the Executive Director

CALIFORNIA STUDENT AID COMMISSION 1955—2005 50 YEARS SERVING STUDENTS

MEMORANDUM

DATE: April 5, 2007

TO: Commissioners

FROM: Diana Fuentes-Michel
Executive Director

Diana Fuentes-Michel

SUBJECT: Chief Internal Auditor Position

As you will recall, the Department of Personnel Administration has approved the California Student Aid Commission's (CSAC) request to reinstate the Chief Internal Auditor position and has given authority to hire at the Senior Management Auditor classification.

The Commission directed me at its February 22-23, 2007, meeting to postpone moving forward with the hiring of the CSAC Chief Internal Auditor based on concerns expressed by Commissioner Dean Johnston, Chair of the CSAC Audit Committee. Commissioner Johnston has asserted that EDFUND's Vice President of Audit Services should continue to oversee the internal audits dealing with the State's participation in the federal student loan program. Commissioner Johnston expanded on his concerns in a comprehensive e-mail message to Janet McDuffie dated March 5, 2007. I have attached a copy of that e-mail message, along with the pdf attachments to that message. The pdf attachments identify certain internal auditing standards from "The International Standards for the Professional Practices of Internal Auditing" (Internal Auditing Standards), as well as Practice Advisories involving those standards, that Commissioner Johnston believed would raise issues with the job duties of the Chief Internal Auditor.

Concern Regarding Roles and Responsibilities of Chief Internal Auditor

Commissioner Johnston's first issue was that the Chief Internal Auditor's objectivity would be compromised if he or she undertook an audit of EDFUND based upon the recommendation of CSAC's Federal Policy and Programs Division (FPPD), because he or she would also be responsible for auditing FPPD. The concern is that by responding to an FPPD request to audit EDFUND, the Chief Internal Auditor would be deemed to have operational responsibility for FPPD, and thus, to the extent his or her job duties included auditing FPPD, the Chief Internal Auditor could be deemed to be violating the Internal Auditing Standards by auditing a program for which he or she was operationally responsible.

Institute of Internal Auditors Concludes No Conflict in CSAC's Chief Internal Auditor Defined Responsibilities

CSAC staff has consulted with the Institute of Internal Auditors on this issue. The Institute of Internal Auditors wrote the Internal Auditing Standards and the Practice Advisories. I have attached a pdf copy of a March 30, 2007, memorandum to me from Janet McDuffie, Acting Chief of FPPD, describing the inquiry to, and response from, the Institute of Internal Auditors. After describing the situation in reference to the State, its Auxiliary, and Division "X", CSAC staff asked: "While Division X is performing its routine responsibilities for monitoring the contract, staff may come across an issue/area/item that needs further review/investigation. Division X may make a recommendation to the State's Executive Management and the State's Internal Audit shop to perform an audit. If the State's Internal Audit Shop performs an audit of the Auxiliary, would this be perceived as a conflict because the State's Internal Audit Shop is also responsible for auditing Division X? Would this violate any of the standards?"

Essentially, the Institute of Internal Auditors concluded that, provided the State's Internal Audit Shop has not had any direct responsibility for managing the operation of the Auxiliary or Division X, or the audit team assigned to the audit has not provided consulting services to the Auxiliary or Division X, there is no conflict by auditing the operations. Please see the attached March 30, 2007, memorandum for the complete question and answer.

Concerns About Addressing Cal Grant Audit Responsibilities

Commissioner Johnston's second issue was that the Commission has neglected the Cal Grant program and operations, and that the internal audit focus should be placed on those areas. Commissioner Johnston's concern about the lack of review of the Cal Grant program and operations is well-founded. As some of the veteran Commissioners may recall, at the April 20-21, 2006, meeting, CSAC staff recommended that the Commission authorize CSAC staff to obtain a consulting contract to undertake a comprehensive review of Cal Grant policies and procedures to ensure compliance with all statutory requirements. The impetus for the recommendation was staff's discovery that the Cal Grant procedures implemented in 2000 had not incorporated a statutory requirement that students were required to have been residents of California at the time of high school graduation to be eligible for Cal Grant Transfer Entitlement awards.

At the time, the Commission limited approval to a review of the Transfer Entitlement process, and chose to rely on the Commission's Internal Audit Plan to accomplish the review of the Cal Grant program. To date, internal audits of the disbursement and reconciliation process and the grade point average collection process have been completed. Since the Commission voted to hire its own Chief Internal Auditor (in response to the recommendation in the Bureau of State Audits report), the Commission has contracted with the Department of Finance to conduct an audit on Cal Grant eligibility of new students. This audit is anticipated to be completed by June 30, 2007. The Commission received an update of this audit at its February 22-23, 2007 meeting.

However, staff disagrees that a current need for greater focus on Cal Grant operations requires or justifies the permanent removal of audit responsibilities relating to the Federal Family Education Loan (FFEL) Program from the job responsibilities of the CSAC Chief Internal Auditor.

CSAC's Responsibility to Oversee Loan Program Includes Audit Function

Staff strongly believes that the final audit responsibilities of a State program belong with a State auditor. While the FFEL Program may have been created by federal law, the Commission's participation in the FFEL Program is a matter of State law. State law expressly authorizes California to participate in the FFEL Program. (Education Code, §69760.) State law establishes the Commission as a state student loan guarantee agency under the FFEL Program and establishes the Commission as the designated state agency for receiving any federal funds for administrative costs and payments of insurance obligations. (Education Code, §69761.5(a).) State law establishes that the contents of the Student Loan Operating Fund are State funds. (Education Code, §69766(c).) Further, the Commission was able to create EDFUND only because State law authorizes the Commission to create an auxiliary to provide operational and administrative services for the Commission's participation in the FFEL Program. (Education Code, §69522(a)(1).)

The Commission would have no authority to participate in the FFEL Program, through EDFUND by any other method, unless State law authorized that participation. Thus, the Commission's participation in the FFEL Program is a State program, subject to the normal accountability and obligations of State programs. The ultimate responsibility for all aspects of the Commission's participation in the FFEL Program, therefore, is a State responsibility. Audit responsibilities relating to the FFEL Program, including audits of the auxiliary organization, properly belong with a State employee. In this case, CSAC's Chief Internal Auditor is the appropriate State officer for these responsibilities.

Recommend Moving Forward with the Chief Internal Auditor Responsible for All Commission Programs, including FFEL Program

The issue of appropriate oversight and who is responsible for discharging the Commission's oversight responsibility is at the heart of Commissioner Johnston's stated concerns. The Commission can not rely solely upon reporting through an annual audit to fulfill its oversight responsibility. An audit is a financial review of expenditures and does not examine programmatic issues related to EDFUND's oversight.

The recent Bureau of State Audits (BSA) report (2005-120) cited that the independence of certain activities at CSAC and EDFUND were in question because the EDFUND Vice President of Audit Services served in multiple roles as Chief of CSAC Internal Audits. The report stated "the CSAC has the statutory responsibility to oversee the activities of EDFUND." (pg. 66). In addition, the BSA report states that the Commission's Internal Audit Services Charter states that "the internal audit activities include the review of EDFUND." The report noted that the then-Chief Internal Audit "is an employee of EDFUND and receives her salary and bonus payments from EDFUND". BSA questioned the EDFUND's internal auditor's "ability to remain impartial and unbiased when choosing potential audit areas or developing audit findings related to Student Aid's oversight of EDFUND" (pg. 68). The BSA auditors argued that "according to the (auditor professional standards), internal auditors must avoid even the appearance of partiality." The BSA auditor report found that CSAC did not comply with certain (auditing) standards as "it missed an opportunity to identify these impairments itself."

The Commission staff recommends that the Commission adopt its recommendation to hire the Senior Management Auditor with responsibility for all of the Commission's programs, including the loan program, as approved by the State Department of Personnel Administration. The Commission's Chief Internal Auditor would be lead staff person responsible for contact with external control agencies whose responsibilities include oversight of the loan program (USED, BSA and DOF). The Chief Internal Auditor would staff the Commission's Audit Committee which jointly meets with EDFUND's Audit Committee. The EDFUND Board of Directors would maintain its own internal audit function, however would not hold ultimate audit authority over the Commission's participation in the federal student loan program.

Essentially, CSAC is the guarantee agency ultimately responsible for the operations of the FFEL Program. EDFUND is not a State entity, it is an auxiliary to the State. Members of EDFUND's management team have a personal stake in everything EDFUND does. The Commission as a volunteer part-time board cannot adequately oversee operations of the loan program without a strong and experienced executive director and staff who are legally responsible and pledge their loyalty to the State of California and its citizens. All CSAC records, including those of EDFUND, must be accessible and in control of the Commission.

And finally, should the Commission direct staff to remove FFEL Program audit responsibilities from the job description, such an action will require additional review and approval from the Department of Personnel Administration. I recommend that the Commission authorize staff to proceed with the hiring of the Chief Internal Auditor with no changes in the job description.

Attachments

From: "Dean Johnston" <DeanJ@sbbcollege.edu>
To: "McDuffie Janet" <jmcduffi@csac.ca.gov>
Date: 3/5/2007 9:02 PM
Subject: RE: Chief Audit Executive Position
Attachments: Independence Objectivity Standards.pdf; Practice_Advisory_1110-1.pdf; Practice_Advisory_1110-2.pdf; Practice_Advisory_113011 A1-1.pdf; Practice_Advisory_113011 A1-2.pdf

CC: <galligani@arches-cal.org>, <roryjdiamond@yahoo.com>, <louisemcclain@cox...

Janet,

I have several concerns against the Chief Audit Executive position conducting audits of EdFund. One of my primary concerns is the Department of Personnel Administration denying the Commission a position that requires a professional certification for someone responsible for auditing a nearly billion dollar program. I discussed this concern with Diana after the Commission meeting and it was my understanding that she has made a follow up request to DPA for a higher level position. If my understanding is not correct, we should make another attempt.

The Chief Audit Executive is expected to report functionally to the Audit Committee and administratively to the Executive Director. The Audit Committee, therefore, is responsible for reviewing and approving the internal auditor's work. The internal auditor should have an impartial, un-biased attitude and avoid conflict of interest situations, as they would prejudice his or her ability to perform the duties objectively. Objectivity can be presumed to be impaired when internal auditors perform an assurance review of any activity for which they had any authority or responsibility. The justification presented to DPA indicated that the auditor would be responsible for conducting audits on behalf of FPPD. At the same time, the auditor will be assessing FPPD's activities which could be perceived as a conflict. If FPPD, through its oversight responsibilities determines that an activity being conducted by EdFund requires an audit, then the Commission should consider hiring external audit services to avoid any conflict.

Attached to this email are five documents provided for your information. One includes the International Standards for the Professional Practice of Internal Auditing specific to independence and objectivity promulgated by the Internal Auditing Standards Board. The use of the word "should" in the Standards represents a mandatory obligation and is defined as such in the glossary to the Standards. The other four documents are Practice Advisories. The Practice Advisories represent best practices strongly recommended and endorsed by the Institute of Internal Auditors as ways to implement the Standards and are not intended to represent all considerations that may be necessary in evaluating the Standards.

The specific wording in the Standards and Practice Advisories that are attached to this email that relate are.....

- The CAE should report functionally to the audit committee. In this context, report functionally means [but is not limited to] approve all decisions regarding the appointment or removal of the CAE.

- The audit committee should have the final authority to review and approve the annual audit plan and all major changes to the plan.

- At all times, the CAE should have open and direct access to the chair of the audit committee and its members; or the chair of the board or full board if appropriate.

- The CAE should report administratively to the chief executive officer [the Executive Director] of the organization. The administrative reporting line should not have ultimate authority over the scope or reporting of results of the internal audit activity.

- Internal auditors should not assume operating responsibilities.

- At any point that assigned activities involve the assumption of operating authority, audit objectivity would be presumed to be impaired with respect to that activity.

- Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.

Beyond the Internal Auditing Standards and Practice Advisories, the Commission's grant program and operational activities are severely neglected from sufficient audit activities placing the Commissioners at great risk in their fiduciary responsibilities. I recommend we focus CSAC resources on the internal auditing functions of the grant programs. We have plenty to accomplish in this arena. We must move forward with hiring not only the Chief Auditing Executive position but also the other additional vacant auditing position. I see no reason to delay this process.

In addition, internal auditing is not oversight. Internal auditing is for the organization's auditor to audit its own organization. Reg Trice's duty statement that was handed out in the commission meeting is not in effect. A new duty statement should be written for the Chief Auditing Executive.

In summary, there is obvious good reason for me, as Chair of Audit, to oppose any and all audits of EdFund by the Commission's internal auditor. Be assured this will be discussed in the Commissions Roles and Responsibilities deliberations.

I apologize for taking one week to respond Janet. I know you have the best interest of the entire organization in mind. We all must continue to work together to ensure the integrity of the programs we administer for our customers.

Dean

From: McDuffie Janet [mailto:jmcduffi@csac.ca.gov]
Sent: Monday, February 26, 2007 9:13 AM
To: Dean Johnston
Cc: Fuentes-Michel Diana; Yamanaka Keith
Subject: Chief Audit Executive Position

You indicated Friday that your only concern regarding the Chief Audit Executive Position was the following reference contained in the classification justification letter to Department of Personnel Administration:

The incumbent will also conduct specific audits on EDFUND as recommended by the Federal Policy and Programs Division as part of that division's oversight function of the loan program and EDFUND.

You agreed to provide the specific Internal Auditing Standard that you used to justify your comment that "these standards would prohibit the internal audit function from performing operational responsibilities of other divisions, which would include performing audits on behalf of FPPD".

It would be helpful to not only have you provide the specific standard, but also a more thorough explanation regarding your opinion on this matter. Thank you.

Independence and Objectivity Standards

1100 - Independence and Objectivity
The internal audit activity should be independent, and internal auditors should be objective in performing their work.

1110 - Organizational Independence
The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.

1110.A1 - The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

1120 - Individual Objectivity
Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.

1130 - Impairments to Independence or Objectivity
If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

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

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

GLOSSARY – definitions:

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

Should - The use of the word "should" in the Standards represents a mandatory obligation.

Practice Advisory 1110-1: Organizational Independence

Interpretation of *Standard 1110* from the *International Standards for the Professional Practice of Internal Auditing*

Related Standard
1110 – Organizational Independence
The chief audit executive should report to a level within the organization that allows the internal audit activity to accomplish its responsibilities.

Nature of this Practice Advisory: *Internal auditors should consider the following suggestions when evaluating organizational independence. This guidance is not intended to represent all the considerations that may be necessary during such an evaluation, but simply a recommended set of items that should be addressed.*

1. Internal auditors should have the support of senior management and the board so that they can gain the cooperation of engagement clients and perform their work free from interference.

2. The chief audit executive (CAE) should be responsible to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations.

3. Ideally, the CAE should report functionally to the board and administratively to the chief executive officer of the organization.

4. The CAE should have direct communication with the board. Regular communication with the board helps assure independence and provides a means for the board and the CAE to keep each other informed on matters of mutual interest.

5. Direct communication occurs when the CAE regularly attends and participates in meetings of the board, which relate to its oversight responsibilities for auditing, financial reporting, organizational governance, and control. The CAE's attendance and participation at these meetings provide an opportunity to be appraised of strategic business and operational developments, and to raise high-level risk, systems, procedures, or control type issues at an early stage. The opportunity is also provided to exchange information concerning the plans and activities of the internal auditing activity. The CAE should meet privately with the board, at least annually.

6. Independence is enhanced when the board concurs in the appointment or removal of the CAE.

Origination date: Jan 5, 2001

Practice Advisory 1110-2: Chief Audit Executive (CAE) Reporting Lines

Interpretation of *Standard 1110* from the
International Standards for the
Professional Practice of Internal Auditing

Related Standard
1110 – Organizational Independence
The chief audit executive should report to a level within the organization that allows the internal audit activity to accomplish its responsibilities.

Nature of this Practice Advisory: *Internal auditors should consider the following guidance when establishing or evaluating the reporting lines and relationships with organizational officials to whom the CAE reports. This guidance is not intended to represent all the considerations that may be necessary during such an evaluation, but simply a recommended set of items that should be considered.*

1. The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* require that the chief audit executive (CAE) report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The IIA believes strongly that to achieve necessary independence, the CAE should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the organization. The following descriptions of what The IIA considers "functional reporting" and "administrative reporting" are provided to help focus the discussion in this Practice Advisory.
   - Functional Reporting — The functional reporting line for the internal audit function is the ultimate source of its independence and authority. As such, The IIA recommends that the CAE report functionally to the audit committee, board of directors, or other appropriate governing authority. In this context, report functionally means that the governing authority would:
     - Approve the overall charter of the internal audit function.
     - Approve the internal audit risk assessment and related audit plan.
     - Receive communications from the CAE on the results of the internal audit activities or other matters that the CAE determines are necessary, including private meetings with the CAE without management present.
     - Approve all decisions regarding the appointment or removal of the CAE.
     - Approve the annual compensation and salary adjustment of the CAE.
     - Make appropriate inquiries of management and the CAE to determine whether there are scope or budgetary limitations that impede the ability of the internal audit function to execute its responsibilities.

- Administrative Reporting — Administrative reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit function. Administrative reporting typically includes:
  - Budgeting and management accounting.
  - Human resource administration, including personnel evaluations and compensation.
  - Internal communications and information flows.
  - Administration of the organization's internal policies and procedures.

2. This advisory focuses on considerations in establishing or evaluating CAE reporting lines. Appropriate reporting lines are critical to achieve the independence, objectivity, and organizational stature for an internal audit function necessary to effectively fulfill its obligations. CAE reporting lines are also critical to ensuring the appropriate flow of information and access to key executives and managers that are the foundations of risk assessment and reporting of results of audit activities. Conversely, any reporting relationship that impedes the independence and effective operations of the internal audit function should be viewed by the CAE as a serious scope limitation, which should be brought to the attention of the audit committee or its equivalent.

3. This advisory also recognizes that CAE reporting lines are impacted by the nature of the organization (public or private as well as relative size); common practices of each country; growing complexity of organizations (joint ventures, multinational corporations with subsidiaries); and the trend toward internal audit groups providing value-added services with increased collaboration on priorities and scope with their clients. Accordingly, while The IIA believes that there is an ideal reporting structure with functional reporting to the audit committee and administrative reporting to the CEO, other relationships can be effective if there are clear distinctions between the functional and administrative reporting lines and appropriate activities are in each line to ensure that the independence and scope of activities are maintained. Internal auditors are expected to use professional judgment to determine the extent to which the guidance provided in this advisory should be applied in each given situation.

4. The *Standards* stress the importance of the CAE reporting to an individual with sufficient authority to promote independence and to ensure broad audit coverage. The *Standards* are purposely somewhat generic about reporting relationships, however, because they are designed to be applicable at all organizations regardless of size or any other factors. Factors that make "one size fits all" unattainable include organization size and type of organization (private, governmental, corporate). Accordingly, the CAE should consider the following attributes in evaluating the appropriateness of the administrative reporting line.
   - Does the individual have sufficient authority and stature to ensure the effectiveness of the function?
   - Does the individual have an appropriate control and governance mind-set to assist the CAE in their role?
   - Does the individual have the time and interest to actively support the CAE on audit issues?
   - Does the individual understand the functional reporting relationship and support it?

5. The CAE should also ensure that appropriate independence is maintained if the individual responsible for the administrative reporting line is also responsible for other activities in the organization, which are subject to internal audit. For example, some CAEs report administratively to the chief financial officer, who is also responsible for the organization's

accounting functions. The internal audit function should be free to audit and report on any activity that also reports to its administrative head if it deems that coverage appropriate for its audit plan. Any limitation in scope or reporting of results of these activities should be brought to the attention of the audit committee.

6. Under the recent move to a stricter legislative and regulatory climate regarding financial reporting around the globe, the CAE's reporting lines should be appropriate to enable the internal audit activity to meet any increased needs of the audit committee or other significant stakeholders. Increasingly, the CAE is being asked to take a more significant role in the organization's governance and risk management activities. The reporting lines of the CAE should facilitate the ability of the internal audit activity to meet these expectations.

7. Regardless of which reporting relationship the organization chooses, several key actions can help assure that the reporting lines support and enable the effectiveness and independence of the internal auditing activity.
   - Functional Reporting:
     - The functional reporting line should go directly to the audit committee or its equivalent to ensure the appropriate level of independence and communication.
     - The CAE should meet privately with the audit committee or its equivalent, without management present, to reinforce the independence and nature of this reporting relationship.
     - The audit committee should have the final authority to review and approve the annual audit plan and all major changes to the plan.
     - At all times, the CAE should have open and direct access to the chair of the audit committee and its members; or the chair of the board or full board if appropriate.
     - At least once a year, the audit committee should review the performance of the CAE and approve the annual compensation and salary adjustment.
     - The charter for the internal audit function should clearly articulate both the functional and administrative reporting lines for the function as well as the principle activities directed up each line.
   - Administrative Reporting:
     - The administrative reporting line of the CAE should be to the CEO or another executive with sufficient authority to afford it appropriate support to accomplish its day-to-day activities. This support should include positioning the function and the CAE in the organization's structure in a manner that affords appropriate stature for the function within the organization. Reporting too low in an organization can negatively impact the stature and effectiveness of the internal audit function.
     - The administrative reporting line should not have ultimate authority over the scope or reporting of results of the internal audit activity.
     - The administrative reporting line should facilitate open and direct communications with executive and line management. The CAE should be able to communicate directly with any level of management, including the CEO.
     - The administrative reporting line should enable adequate communications and information flow such that the CAE and the internal audit function have an adequate and timely flow of information concerning the activities, plans, and business initiatives of the organization.
     - Budgetary controls and considerations imposed by the administrative reporting line should not impede the ability of the internal audit function to accomplish its mission.

8. CAEs should also consider their relationships with other control and monitoring functions (risk management, compliance, security, legal, ethics, environmental, external audit) and facilitate the reporting of material risk and control issues to the audit committee.

Origination date: Dec 3, 2002

Practice Advisory 1130.A1-1: Assessing Operations for Which Internal Auditors Were Previously Responsible

Interpretation of *Standard 1130.A1* from the *International Standards for the Professional Practice of Internal Auditing*

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

Nature of this Practice Advisory: *Internal auditors should consider the following suggestions when faced with a situation where the auditor has been assigned to assess an operation for which they were previously responsible. This guidance is not intended to represent all the considerations that may be necessary during such an evaluation, but simply a recommended set of items that should be addressed.*

1. Internal auditors should not assume operating responsibilities. If senior management directs internal auditors to perform non-audit work, it should be understood that they are not functioning as internal auditors. Moreover, objectivity is presumed to be impaired when internal auditors perform an assurance review of any activity for which they had authority or responsibility within the past year. This impairment should be considered when communicating audit engagement results.
   - If internal auditors are directed to perform non-audit duties that may impair objectivity, such as preparation of bank reconciliations, the chief audit executive should inform senior management and the board that this activity is not an assurance audit activity; and, therefore, audit-related conclusions should not be drawn.
   - In addition, when operating responsibilities are assigned to the internal audit activity, special attention must be given to ensure objectivity when a subsequent assurance engagement in the related operating area is undertaken. Objectivity is presumed to be impaired when internal auditors audit any activity for which they had authority or responsibility within the past year. These facts should be clearly stated when communicating the results of an audit engagement relating to an area where an auditor had operating responsibilities.

2. At any point that assigned activities involve the assumption of operating authority, audit objectivity would be presumed to be impaired with respect to that activity.

3. Persons transferred to or temporarily engaged by the internal audit activity should not be assigned to audit those activities they previously performed until a reasonable period of time

(at least one year) has elapsed. Such assignments are presumed to impair objectivity, and additional consideration should be exercised when supervising the engagement work and communicating engagement results.

4. The internal auditor's objectivity is not adversely affected when the auditor recommends standards of control for systems or reviews procedures before they are implemented. The auditor's objectivity is considered to be impaired if the auditor designs, installs, drafts procedures for, or operates such systems.

5. The occasional performance of non-audit work by the internal auditor, with full disclosure in the reporting process, would not necessarily impair independence. However, it would require careful consideration by management and the internal auditor to avoid adversely affecting the internal auditor's objectivity.

Origination date: Jan 5, 2001

Practice Advisory 1130.A1-2: Internal Auditing's Responsibility for Other (Non-audit) Functions

Interpretation of *Standard 1130.A1* from the *International Standards for the Professional Practice of Internal Auditing*

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

Nature of this Practice Advisory: *The following guidance is offered to internal auditors faced with accepting responsibility for non-audit, operational functions or duties. Acceptance of such responsibilities can impair independence and objectivity and, if possible, should be avoided. This guidance is not intended to represent all the considerations that may be necessary in evaluating such responsibilities or assignments.*

1. Some internal auditors have been assigned or accepted non-audit duties due to a variety of business reasons that make sense to management of the organization. Internal auditors are more frequently being asked to perform roles and responsibilities that may impair independence or objectivity. Given the increasing demand on organizations, both public and private, to develop more efficient and effective operations and to do so with fewer resources, some internal audit activities are being directed by their organization's management to assume responsibility for operations that are subject to periodic internal auditing assessments.

2. When the internal audit activity or individual internal auditor is responsible for, or management is considering assigning, an operation that it might audit, the internal auditor's independence and objectivity may be impaired. The internal auditor should consider the following factors in assessing the impact on independence and objectivity:
   - The requirements of The IIA's Code of Ethics and *International Standards for the Professional Practice of Internal Auditing (Standards)*;
   - Expectations of stakeholders that may include the shareholders, board of directors, audit committee, management, legislative bodies, public entities, regulatory bodies, and public interest groups;
   - Allowances and/or restrictions contained in the internal audit activity charter;
   - Disclosures required by the *Standards*; and
   - Subsequent audit coverage of the activities or responsibilities accepted by the internal auditor.

3. Internal auditors should consider the following factors to determine an appropriate course of action when presented with the opportunity of accepting responsibility for a non-audit function:

   A. The IIA's Code of Ethics and *Standards* require the internal audit activity to be independent, and internal auditors to be objective in performing their work.
      - If possible, internal auditors should avoid accepting responsibility for non-audit functions or duties that are subject to periodic internal auditing assessments. If this is not possible, then;
      - Impairment to independence and objectivity are required to be disclosed to appropriate parties, and the nature of the disclosure depends upon the impairment.
      - Objectivity is presumed to be impaired if an auditor provides assurance services for an activity for which the auditor had responsibility within the previous year.
      - If on occasion management directs internal auditors to perform non-audit work, it should be understood that they are not functioning as internal auditors.

   B. Expectations of stakeholders, including regulatory or legal requirements, should be evaluated and assessed in relation to the potential impairment.

   C. If the internal audit activity charter contains specific restrictions or limiting language regarding the assignment of non-audit functions to the internal auditor, then these restrictions should be disclosed and discussed with management. If management insists on such an assignment, the auditor should disclose and discuss this matter with the audit committee or appropriate governing body. If the charter is silent on this matter, the guidance noted in the points below should be considered. All the points noted below are subordinated to the language of the charter.

   D. **Assessment** — The results of the assessment should be discussed with management, the audit committee, and/or other appropriate stakeholders. A determination should be made regarding a number of issues, some of which affect one another:
      - The significance of the operational function to the organization (in terms of revenue, expenses, reputation, and influence) should be evaluated.
      - The length or duration of the assignment and scope of responsibility should be evaluated.
      - Adequacy of separation of duties should be evaluated.
      - The potential impairment to objectivity or independence or the appearance of such impairment should be considered when reporting audit results.

   E. **Audit of the Function and Disclosure** — Given that the internal audit activity has operational responsibilities and that operation is part of the audit plan, there are several avenues for the auditor to consider.
      - The audit may be performed by a contracted, third-party entity, by external auditors, or by the internal audit function. In the first two situations, impairment of objectivity is minimized by the use of auditors outside the organization. In the latter case, objectivity would be impaired.
      - Individual auditors with operational responsibility should not participate in the audit of the operation. If possible, auditors conducting the assessment should be supervised by, and report the results of the assessment to, those whose independence or objectivity is not impaired.
      - Disclosure should be made regarding the operational responsibilities of the auditor for the function, the significance of the operation to the organization (in terms of

revenue, expenses, or other pertinent information), and the relationship of those who audited the function to the auditor.

- Disclosure of the auditor's operational responsibilities should be made in the related audit report and in the auditor's standard communication to the audit committee or other governing body.

Origination date: Feb 1, 2003

CALIFORNIA STUDENT AID COMMISSION
1955—2005
50 YEARS SERVING STUDENTS

MEMORANDUM

DATE: March 30, 2007

TO: Diana Fuentes-Michel
Executive Director

FROM: Janet McDuffie Janet
Chief, Management Services Division

SUBJECT: Commission's Chief Audit Executive Position

At the February 22, 2007 Commission Meeting and in subsequent emails to CSAC staff, Commissioner Johnston expressed concerns regarding the Chief Audit Executive Position for the Commission.

Commissioner Johnston cited potential impairments to independence for the Commission's Chief Audit Executive position as set forth in the duty statement and Department of Personnel Administration justification letter. Specifically, in the document Commissioner Johnston provided during the Commission meeting, he indicated that "Internal Auditing Standards prohibit the internal audit function from performing operational responsibilities of other divisions, which would include performing audits on behalf of FPPD."

CSAC staff does not agree with Commissioner Johnston on this issue. In an attempt to seek clarification from a reliable source, CSAC staff contacted the Institute of Internal Auditors (IIA) for guidance. Specifically, staff contacted the Global Practices Center Department which is charged with writing and providing guidance for "The International Standards for the Professional Practices of Internal Auditing Standards." These standards are the mandatory guidance for all Institute of Internal Auditor members and Certified Internal Auditors. (Attachment A is a copy of the question and organizational charts provided to IIA along with the answer they provided CSAC staff).

The IIA response indicates that providing CSAC's Internal Audit Division has not had any direct responsibility for managing the operation of EDFUND or FPPD, or the audit team assigned to the audit of EDFUND has not provided consulting services to EDFUND or FPPD there is no conflict by auditing the operations of EDFUND. IIA also stated that it appears from the organization charts that there is enough separation of duties to provide control and that internal audit does report to the audit committee, which gives the internal audit shop a sounding board if they ever believe their independence is impaired due to managements influence. IIA indicated that FPPD is for monitoring and reporting, and CSAC's Internal Audit Division should be auditing FPPD operation processes as part of the normal audit cycle.

Commissioner Johnston also expressed his concern that the Department of Personnel Administration (DPA) was "denying the Commission a position that requires a professional certification for someone responsible for auditing a nearly billion dollar program". Commissioner Johnston requested that CSAC staff to work with DPA to pursue a higher classification that would require professional certification. The State's classification specifications for the Management Auditor Series which includes both the Senior Management Auditor and the next highest classification level of Supervising Management Auditor. These specifications provides the minimum qualifications (related to education and experience) for these classifications. These specifications do not require any specific certifications (such as CPA, Certified Internal Auditor, (CIA) Certified Government Auditing Professional (CGAP), etc) at either level. Because we cannot require any of these certifications as a hiring condition the Job Opportunity Bulletin advertising the Senior Management Auditor position does indicate various certifications (CPA, CIA, CGAP and CISA) as desirable qualities, as noted at the Commission meeting.

The specifications also provide the guidelines for determine the appropriate allocation of each level based on

> "Variety and complexity of audit assignments, scope and complexity of audit objectives and programs, independence of action and level of decision-making authority, level and variety of professional contacts, degree of administrative and supervisory responsibilities, supervision received, responsibility for program and policy imple*mentation, and impact of the audit program on the plans, procedures, and policies* of the organizations audited."

DPA has indicated that the Senior Management Auditor is the appropriate classification for the Commission's Chief Audit Executive based on the duties and justification and the following allocation guidelines in the classification specifications noted below.

Senior Management Auditor

> Either (1) is responsible for planning, organizing, and directing the work of a group of audit teams performing management audits of several organizations or may supervise a large audit team conducting a sensitive complex audit; or (2) directs an internal audit program of a State department requiring a variety of complex technical management audits.

Supervising Management Auditor

> Either (1) is responsible for long-range planning, directing, and coordinating the total audit activities of several State agencies or large State organizations; or (2) directs and is responsible for the total management audit activities of an internal audit program in a State department requiring management audits of several large internal governmental programs, or agencies under contract.

Based on the response from IIA and given the importance of the position and the urgency the Commission has placed on hiring the Chief Audit Executive, CSAC staff would like the authorization to move forward with the hiring of the Chief Audit Executive at the Senior Management Auditor level.

ATTACHMENT A

QUESTION:

We have a State Agency that is charged with administering State and Federal programs. The State Agency created an Auxiliary (non-profit corporation) and entered into a contract with the Auxiliary to provide operational and support services for the federal program.

The State Agency is required to conduct regular performance evaluations of the Auxiliary in furtherance of the State Agency's fiscal and fiduciary responsibilities.

The State Agency has a Board of Directors and is responsible for appointing the members of the Auxiliary Board. Both Boards have Audit Committees and both the State Agency and the Auxiliary have Internal Audit shops with CAEs. (Organizational charts are provided for review)

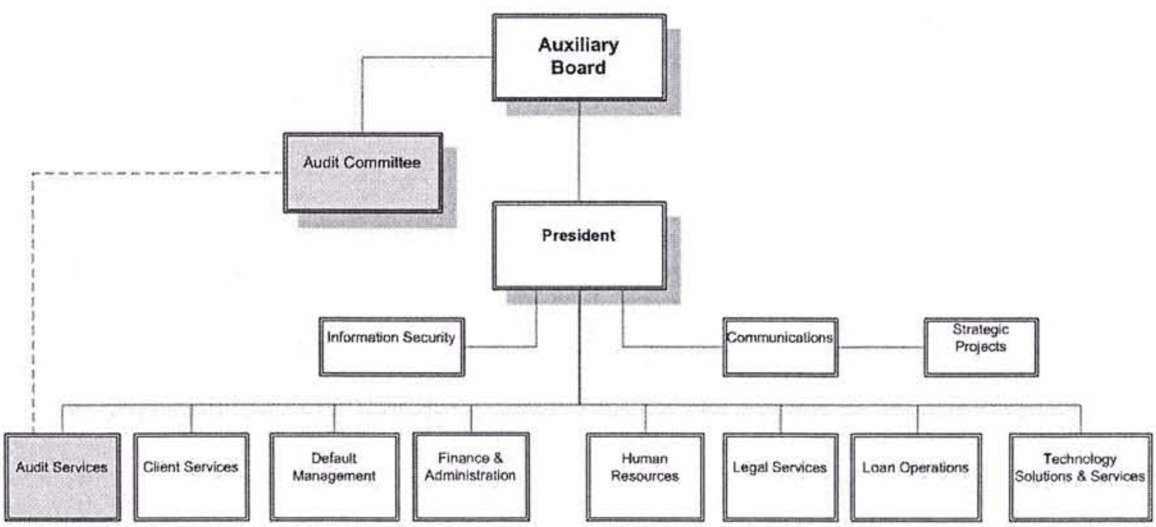
The State Agency has a dedicated Division (Division X) that is responsible for monitoring the contract between the State and the Auxiliary.

The State's Internal Audit Shop is responsible for performing audits on all the divisions including Division X which is responsible for monitoring the contract between the State Agency and Auxiliary.

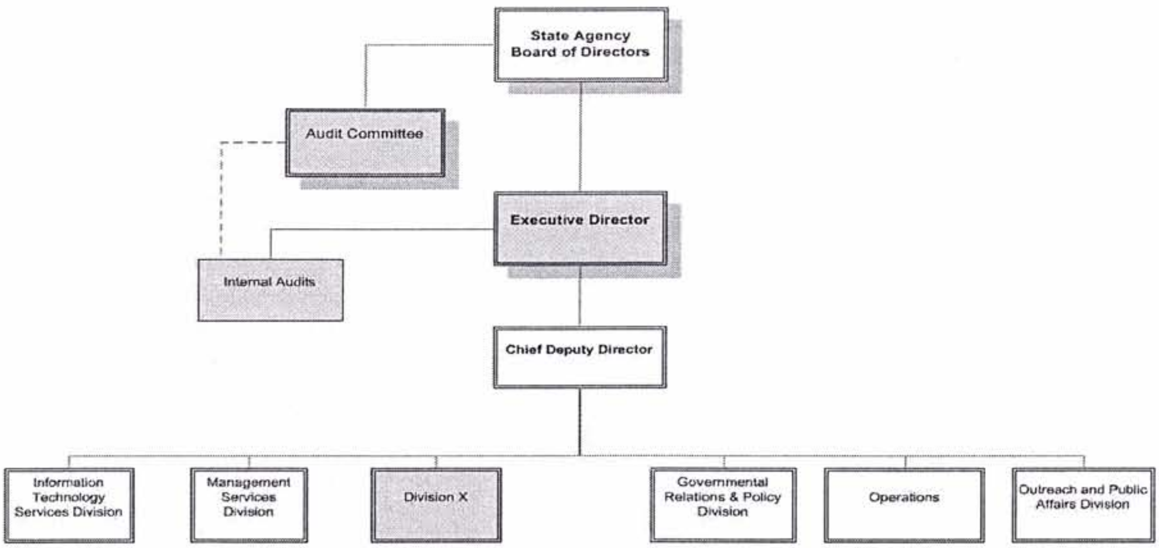
While Division X is performing its routine responsibilities for monitoring the contract, staff may come across an issue/area/item that needs further review/investigation. Division X may make a recommendation to the State's Executive Management and the State's Internal Audit shop to perform an audit.

If the State's Internal Audit Shop performs an audit of the Auxiliary, would this be perceived as a conflict because the State's Internal Audit Shop is also responsible for auditing Division X? Would this violate any of the standards?

AUXILIARY AGENCY



STATE AGENCY



ANSWER:

The following is a rather lengthy answer to your question. Providing the State's Internal Audit Shop has not had any direct responsibility for managing the operation of the Auxiliary or Division X, or the audit team assigned to the audit has not provided consulting services to the Auxiliary or Division X there is no conflict by auditing the operations. It appears from the organization charts that there is enough separation of duties to provide control. I see that internal audit does report to the audit committee, which gives you a sounding board if you ever believe your independence is impaired due to managements influence. Division X is just for monitoring and reporting, and internal audit should be auditing Division X operation processes as part of the normal audit cycle.

In addition, I assume you are following the Red Book Standards or Yellow Book, which allows for audit departments to perform operation functions (advisory services) if required, but the same auditor(s) should not review their own work. Therefore, a different audit team would have to be assigned for the engagement if this situation arose. If a period of time has passed since the advisory service (one or more years) there may not be a conflict since things change rapidly, but this is a call only your audit management could make.

By following the Professional Practices Framework and adhering to the code of conduct along with all the standards you are in compliance with what is acceptable.

Attribute Standard 1130

Impairments to Independence or Objectivity

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

Implementation Standard 1130.A1 (Assurance Engagements)

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

Implementation Standard 1130.A2 (Assurance Engagements)
Assurance engagements for functions over which the chief audit executive has responsibility should be overseen by a party outside the internal audit activity.

Implementation Standard 1130.C1 (Consulting Engagements)
Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

Practice Advisory 1130.A1-1:
Assessing Operations for Which Internal Auditors Were Previously Responsible PA1130.A1-1

Implementation Standard 1130.C2 (Consulting Engagements)
If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement.

Also, with the Audit Executive reporting periodically to an engaged Audit Committee with full transparency there should never be a question of independence or impairment, since the committee would have full disclosure about the work being performed and the team assigned.

Performance Standard 2060

Reporting to the Board and Senior Management
The chief audit executive should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management.