INCLINE VILLAGE
GENERAL IMPROVEMENT DISTRICT
ONE DISTRICT ~ ONE TEAM

NOTICE OF MEETING

The Audit Committee Meeting of the Incline Village General Improvement District will be held starting at 4:00 PM on October 5, 2023 in the Boardroom at 893 Southwood Boulevard, Incline Village, Nevada.

Public comment is allowed and the public is welcome to make their public comment via telephone (the telephone number is (877) 853-5247 and the webinar ID will be posted to our website on the day of the meeting). The meeting will be available for viewing at https://livestream.com/accounts/3411104.

A. CALL TO ORDER

B. ROLL CALL OF THE AUDIT COMMITTEE MEMBERS *Chairman Chris Nolet (At-Large Member). Vito Brandle (At-Large Member), Raymond Tulloch (Trustee), and Sara Schmitz (Trustee), Vacant (At-Large Member).*

C. PUBLIC COMMENTS - *Unless otherwise determined, the time limit shall be three (3) minutes for each person wishing to make a public comment. Unless otherwise permitted by the Chair, no person shall be allowed to speak more than once on any single agenda item. Not to include comments on General Business items with scheduled public comment. The Board of Trustees may address matters brought up during public comment at the conclusion of the comment period but may not deliberate on any non-agendized item.*

D. APPROVAL OF AGENDA *(for possible action)*

The Audit Committee may make a motion for a flexible agenda which is defined as taking items on the agenda out of order; combining agenda items with other agenda items; removing items from the agenda; moving agenda items to an agenda of another meeting, or voting on items in a block.

-OR-

The Audit Committee may make a motion to accept and follow the agenda as submitted/posted.

E. GENERAL BUSINESS ITEMS (for possible action)

1. **SUBJECT:** Verbal report from Bobby Magee on the state of the financial reporting team and the backlog of known accounting and reporting challenges **and** discuss possible delays in completing the 2023 Annual Comprehensive Financial Report (ACFR) audit and providing a timely filing with the State of Nevada.

2. **SUBJECT:** Verbal report from Bobby Magee on the status of the proposed Due Diligence Audit, which is separate from the United States Generally Accepted Auditing Standards (GAAS) audit of the 2023 ACFR.

3. **SUBJECT:** Verbal report from Davis Farr on how Audit Standard 99 – "Consideration of Fraud in a Financial Statement Audit" will impact the audit of the District's 2023 ACFR ***- pages 3 - 54***

4. **SUBJECT:** Verbal presentation from Erin Feore, Director of Human Resources, concerning a whistleblower matter.

5. **SUBJECT:** Verbal Presentation by Chris Nolet, Audit Committee Chair, concerning one (1) whistleblower matter.

NOTICE OF MEETING

F. LONG RANGE CALENDAR REVIEW

1. **SUBJECT:** Discussion of scheduling Audit Committee meetings through December 31, 2023.

G. CONSENT CALENDAR (for possible action)

1. **SUBJECT:** Meeting Minutes of July 24, 2023 - ***pages 55 - 170***

H. CLOSING REMARKS (for possible action)

1. **SUBJECT:** Audit Committee Chair Chris Nolet

I. PUBLIC COMMENTS - *Conducted in accordance with Nevada Revised Statutes Chapter 241.020 and limited to a maximum of three (3) minutes in duration.*

J. ADJOURNMENT (for possible action)

CERTIFICATION OF POSTING OF THIS AGENDA

I hereby certify that on or before 9:00 a.m. on Monday, October 2, 2023, a copy of this agenda (Audit Committee Session of October 5, 2023) was delivered to the post office addressed to the people who have requested to receive copies of IVGID's agendas; copies were e-mailed to those people who have requested; and a copy was posted, physically or electronically, at the following locations in accordance with Assembly Bill 213:

1. IVGID Anne Vorderbruggen Building (893 Southwood Boulevard, Incline Village, Nevada; Administrative Offices)
2. IVGID's website (www.yourtahoeplace.com/ivgid/board-of-trustees/meetings-and-agendas)
3. State of Nevada public noticing website (https://notice.nv.gov/)
4. IVGID's Recreation Center (980 Incline Way, Incline Village, Nevada)

/s/ Heidi H. White
Heidi H. White
District Clerk (e-mail: hhw@ivgid.org/phone # 775-832-1268)

Audit Committee: *Chairman Chris Nolet (At-Large Member), Vito Brandle (At-Large Member), Raymond Tulloch (Trustee), and Sara Schmitz (Trustee), Vacant (At-Large Member)*

Notes: *Items on the agenda may be taken out of order; combined with other items; removed from the agenda; moved to the agenda of another meeting; moved to or from the Consent Calendar section; or may be voted on in a block. Items with a specific time designation will not be heard prior to the stated time, but may be heard later. Those items followed by an asterisk (*) are items on the agenda upon which the Board of Trustees will take no action. Members of the public who are disabled and require special accommodations or assistance at the meeting are requested to call IVGID at 832-1100 at least 24 hours prior to the meeting.* ***IVGID'S agenda packets are available at IVGID's website, www.yourtahoeplace.com; go to "Board Meetings and Agendas".***

AU Section 316

Consideration of Fraud in a Financial Statement Audit

(Supersedes SAS No. 82.)

Source: SAS No. 99; SAS No. 113.

Effective for audits of financial statements for periods beginning on or after December 15, 2002, unless otherwise indicated.

Introduction and Overview

.01 Section 110, *Responsibilities and Functions of the Independent Auditor*, paragraph .02, states, "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. [footnote omitted]"[1] This section establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).[2]

.02 The following is an overview of the organization and content of this section:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs .05 through .12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph .13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs .14 through .18.)

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[1] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in section 317, *Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors (see section 312, *Audit Risk and Materiality in Conducting an Audit*, or fraud).

[2] Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). AT section 101, *Attest Engagements*, and CS section 100, *Consulting Services: Definitions and Standards*, provide guidance to accountants relating to the performance of such services.

- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by
  - *a.* Inquiring of management and others within the entity about the risks of fraud. (See paragraphs .20 through .27.)
  - *b.* Considering the results of the analytical procedures performed in planning the audit. (See paragraphs .28 through .30.)
  - *c.* Considering fraud risk factors. (See paragraphs .31 through .33, and the Appendix, "Examples of Fraud Risk Factors" [paragraph .85].)
  - *d.* Considering certain other information. (See paragraph .34.)
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs .35 through .42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs .43 through .45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. (See paragraph .46 through .49.) The section requires the auditor to respond to the results of the risk assessment in three ways:
  - *a.* A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned. (See paragraph .50.)
  - *b.* A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed. (See paragraphs .51 through .56.)
  - *c.* A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls. (See paragraphs .57 through .67.)
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs .68 through .74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs .75 through .78.)
- *Communicating about fraud to management, those charged with governance, and others.* This section provides guidance regarding the auditor's communications about fraud to management, those charged with governance, and others. (See paragraphs .79 through .82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph .83.)

[Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.03 The requirements and guidance set forth in this section are intended to be integrated into an overall audit process, in a logical manner that is consistent with the requirements and guidance provided in other sections, including section 311, *Planning and Supervision*; section 312, *Audit Risk and Materiality in Conducting an Audit*; section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 318 *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. Even though some requirements and guidance set forth in this section are presented in a manner that suggests a sequential audit process, auditing in fact involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly the sequence of the requirements and guidance in this section may be implemented differently among audit engagements. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statements on Auditing Standards No. 109 and No. 110.]

.04 Although this section focuses on the auditor's consideration of fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud.[3] That responsibility is described in section 110.03, which states, "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, authorize, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements." Management, along with those charged with governance, should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those charged with governance fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 106. Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Description and Characteristics of Fraud

.05 Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. For purposes of the section, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.[4]

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[3] In its October 1987 report, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, noted, "The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management, starting with the chief executive officer, sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start with the reporting company."

[4] Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether the misstatement is intentional or not.

.06 Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

- *Misstatements arising from fraudulent financial reporting* are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles (GAAP).[5] Fraudulent financial reporting may be accomplished by the following:

  — Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared

  — Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information

  — Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

  Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management representatives rationalize the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.

- *Misstatements arising from misappropriation of assets* (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services that have not been received. Misappropriation of assets may be accompanied by false or misleading records or documents, possibly created by circumventing controls. The scope of this section includes only those misappropriations of assets for which the effect of the misappropriation causes the financial statements not to be fairly presented, in all material respects, in conformity with GAAP.

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

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[5] Reference to generally accepted accounting principles (GAAP) includes, where applicable, a comprehensive basis of accounting other than GAAP as defined in section 623, *Special Reports*, paragraph .04.

.08 Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[6] Management can either direct employees to perpetrate fraud or solicit their help in carrying it out. In addition, management personnel at a component of the entity may be in a position to manipulate the accounting records of the component in a manner that causes a material misstatement in the consolidated financial statements of the entity. Management override of controls can occur in unpredictable ways.

.09 Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. For example, management that engages in fraudulent financial reporting might alter shipping documents. Employees or members of management who misappropriate cash might try to conceal their thefts by forging signatures or falsifying electronic approvals on disbursement authorizations. An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. In addition, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed.

.10 Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. For example, through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity to explain an unexpected result of an analytical procedure. As another example, the auditor may receive a false confirmation from a third party that is in collusion with management.

.11 Although fraud usually is concealed and management's intent is difficult to determine, the presence of certain conditions may suggest to the auditor the possibility that fraud may exist. For example, an important contract may be missing, a subsidiary ledger may not be satisfactorily reconciled to its control account, or the results of an analytical procedure performed during the audit may not be consistent with expectations. However, these conditions may be the result of circumstances other than fraud. Documents may legitimately have been lost or misfiled; the subsidiary ledger may be out of balance with its control account because of an unintentional accounting error; and unexpected analytical relationships may be the result of unanticipated changes in underlying economic factors. Even reports of alleged fraud may not always be reliable because an employee or outsider may be mistaken or may be motivated for unknown reasons to make a false allegation.

.12 As indicated in paragraph .01, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or

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[6] Frauds have been committed by management override of existing controls using such techniques as (*a*) recording fictitious journal entries, particularly those recorded close to the end of an accounting period to manipulate operating results, (*b*) intentionally biasing assumptions and judgments used to estimate account balances, and (*c*) altering records and terms related to significant and unusual transactions.

error.[7] However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

The Importance of Exercising Professional Skepticism

.13 Due professional care requires the auditor to exercise professional skepticism. See section 230, *Due Professional Care in the Performance of Work*, paragraphs .07 through .09. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

.14 Prior to or in conjunction with the information-gathering procedures described in paragraphs .19 through .34 of this section, members of the audit team should discuss the potential for material misstatement due to fraud. The discussion should include:

- An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. (See paragraph .15.)
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud. (See paragraph .16.)

.15 The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. The discussion should occur with an attitude that includes a questioning mind as described in paragraph .16 and, for this purpose,

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[7] For a further discussion of the concept of reasonable assurance, see section 230, *Due Professional Care in the Performance of Work*, paragraphs .10 through .13.

setting aside any prior beliefs the audit team members may have that management is honest and has integrity. In this regard, the discussion should include a consideration of the risk of management override of controls.[8] Finally, the discussion should include how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

.16 The discussion among the audit team members should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit, as described in paragraph .13. This should lead the audit team members to continually be alert for information or other conditions (such as those presented in paragraph .68) that indicate a material misstatement due to fraud may have occurred. It should also lead audit team members to thoroughly probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, experts in the firm, rather than rationalize or dismiss information or other conditions that indicate a material misstatement due to fraud may have occurred.

.17 Although professional judgment should be used in determining which audit team members should be included in the discussion, the discussion ordinarily should involve the key members of the audit team. A number of factors will influence the extent of the discussion and how it should occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor to consider in planning the discussions is whether to include specialists assigned to the audit team. For example, if the auditor has determined that a professional possessing information technology skills is needed on the audit team (see section 311.31), it may be useful to include that individual in the discussion. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 108.]

.18 Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit—for example, in evaluating the risks of material misstatement due to fraud at or near the completion of the field work. (See paragraph .74 and footnote 28.)

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.19 Section 314 provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35 through .42) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs .20 through .27.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28 through .30.)

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[8] See footnote 6.

c. Consider whether one or more fraud risk factors exist. (See paragraphs .31 through .33, and the Appendix [paragraph .85].)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34.)

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

Making Inquiries of Management and Others Within the Entity About the Risks of Fraud

.20 The auditor should inquire of management about:[9]

- Whether management has knowledge of any fraud or suspected fraud affecting the entity
- Whether management is aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others
- Management's understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or account balances or classes of transactions for which a risk of fraud may be likely to exist
- Programs and controls[10] the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls. For examples of programs and controls an entity may implement to prevent, deter, and detect fraud, see the exhibit titled "Management Antifraud Programs and Controls" [paragraph .86] at the end of this section.
- For an entity with multiple locations, (*a*) the nature and extent of monitoring of operating locations or business segments, and (*b*) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist
- Whether and how management communicates to employees its views on business practices and ethical behavior

.21 The inquiries of management also should include whether management has reported to those charged with governance[[11]] on how the entity's internal control[12] serves to prevent, deter, or detect material misstatements due to fraud. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.22 The auditor also should inquire directly of those charged with governance (or the audit committee or at least its chair) regarding their views about

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[9] In addition to these inquiries, section 333, *Management Representations*, requires the auditor to obtain selected written representations from management regarding fraud.

[10] Section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, paragraph .41, defines internal control and its five interrelated components (the control environment, risk assessment, control activities, information and communication, and monitoring). Entity programs and controls intended to address the risks of fraud may be part of any of the five components discussed in section 314. [Footnote revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

[[11]] [Footnote deleted due to conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

[12] See footnote 10.

the risks of fraud and whether those charged with governance have knowledge of any fraud or suspected fraud affecting the entity. An entity's audit committee sometimes assumes an active role in oversight of the entity's assessment of the risks of fraud and the programs and controls the entity has established to mitigate these risks. The auditor should obtain an understanding of how the audit committee exercises oversight activities in that area. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.23 For entities that have an internal audit function, the auditor also should inquire of appropriate internal audit personnel about their views about the risks of fraud, whether they have performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any fraud or suspected fraud.

.24 In addition to the inquiries outlined in paragraphs .20 through .23, the auditor should inquire of others within the entity about the existence or suspicion of fraud. The auditor should use professional judgment to determine those others within the entity to whom inquiries should be directed and the extent of such inquiries. In making this determination, the auditor should consider whether others within the entity may be able to provide information that will be helpful to the auditor in identifying risks of material misstatement due to fraud—for example, others who may have additional knowledge about or be able to corroborate risks of fraud identified in the discussions with management (see paragraph .20) or those charged with governance (see paragraph .22). [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.25 Examples of others within the entity to whom the auditor may wish to direct these inquiries include:

- Employees with varying levels of authority within the entity, including, for example, entity personnel with whom the auditor comes into contact during the course of the audit in obtaining (*a*) an understanding of the entity's systems and internal control, (*b*) in observing inventory or performing cutoff procedures, or (*c*) in obtaining explanations for fluctuations noted as a result of analytical procedures
- Operating personnel not directly involved in the financial reporting process
- Employees involved in initiating, recording, or processing complex or unusual transactions—for example, a sales transaction with multiple elements, or a significant related party transaction
- In-house legal counsel

.26 The auditor's inquiries of management and others within the entity are important because fraud often is uncovered through information received in response to inquiries. One reason for this is that such inquiries may provide individuals with an opportunity to convey information to the auditor that otherwise might not be communicated. Making inquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from that of individuals involved in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management, or alternatively, might provide information regarding the possibility of management override of controls—for example, a response from an employee indicating an unusual change in the way transactions have been processed. In addition, the auditor may obtain information from these inquiries regarding how effectively management has communicated standards of ethical behavior to individuals throughout the organization.

.27 The auditor should be aware when evaluating management's responses to the inquiries discussed in paragraph .20 that management is often in the best position to perpetrate fraud. The auditor should use professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. However, when responses are inconsistent among inquiries, the auditor should obtain additional audit evidence to resolve the inconsistencies.

Considering the Results of the Analytical Procedures Performed in Planning the Audit

.28 Section 329, *Analytical Procedures*, paragraphs .04 and .06, requires that analytical procedures be performed in planning the audit with an objective of identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning implications. In performing analytical procedures in planning the audit, the auditor develops expectations about plausible relationships that are reasonably expected to exist, based on the auditor's understanding of the entity and its environment. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying the risks of material misstatement due to fraud.

.29 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. An example of such an analytical procedure that addresses this objective is a comparison of sales volume, as determined from recorded revenue amounts, with production capacity. An excess of sales volume over production capacity may be indicative of recording fictitious sales. As another example, a trend analysis of revenues by month and sales returns by month during and shortly after the reporting period may indicate the existence of undisclosed side agreements with customers to return goods that would preclude revenue recognition.[13]

.30 Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, because such analytical procedures generally use data aggregated at a high level, the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning should be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

Considering Fraud Risk Factors

.31 Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

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[13] See paragraph .70 for a discussion of the need to update these analytical procedures during the overall review stage of the audit.

.32 When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud.

.33 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in the Appendix [paragraph .85]. These illustrative risk factors are classified based on the three conditions generally present when fraud exists: *incentive/pressure* to perpetrate fraud, an *opportunity* to carry out the fraud, and *attitude/rationalization* to justify the fraudulent action. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Considering Other Information That May Be Helpful in Identifying Risks of Material Misstatement Due to Fraud

.34 The auditor should consider other information that may be helpful in identifying risks of material misstatement due to fraud. Specifically, the discussion among the engagement team members (see paragraphs .14 through .18) may provide information helpful in identifying such risks. In addition, the auditor should consider whether information from the results of (*a*) procedures relating to the acceptance and continuance of clients and engagements[14] and (*b*) reviews of interim financial statements may be relevant in the identification of such risks. Finally, as part of the consideration of audit risk at the individual account balance or class of transaction level (see section 312.17 through .26), the auditor should consider whether identified inherent risks would provide useful information in identifying the risks of material misstatement due to fraud (see paragraph .39). [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

Identifying Risks That May Result in a Material Misstatement Due to Fraud[15]

Using the Information Gathered to Identify Risk of Material Misstatements Due to Fraud

.35 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered (see paragraphs .19 through .34) in the context of the three conditions present when a material misstatement due to fraud occurs—that is, incentives/pressures,

[14] See paragraphs .27–.36 of QC section 10B, *A Firm's System of Quality Control*. [Footnote amended due to issuance of SQCS No. 7, December 2008.]

[15] Section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to identify and assess the risk of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances and disclosures. See section 314.102. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 2006, by Statement on Auditing Standards No. 113.]

opportunities, and attitudes/rationalizations (see paragraph .07). However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks. Although the risk of material misstatement due to fraud may be greatest when all three fraud conditions are observed or evident, the auditor cannot assume that the inability to observe one or two of these conditions means there is no risk of material misstatement due to fraud. In fact, observing that individuals have the requisite attitude to commit fraud, or identifying factors that indicate a likelihood that management or other employees will rationalize committing a fraud, is difficult at best.

.36 In addition, the extent to which each of the three conditions referred to above are present when fraud occurs may vary. In some instances the significance of incentives/pressures may result in a risk of material misstatement due to fraud, apart from the significance of the other two conditions. For example, an incentive/pressure to achieve an earnings level to preclude a loan default, or to "trigger" incentive compensation plan awards, may alone result in a risk of material misstatement due to fraud. In other instances, an easy opportunity to commit the fraud because of a lack of controls may be the dominant condition precipitating the risk of fraud, or an individual's attitude or ability to rationalize unethical actions may be sufficient to motivate that individual to engage in fraud, even in the absence of significant incentives/pressures or opportunities.

.37 The auditor's identification of fraud risks also may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. For example, in the case of a larger entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of the audit committee and the internal audit function, and the existence and enforcement of a formal code of conduct. In the case of a smaller entity, some or all of these considerations may be inapplicable or less important, and management may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and management by example. Also, the risks of material misstatement due to fraud may vary among operating locations or business segments of an entity, requiring an identification of the risks related to specific geographic areas or business segments, as well as for the entity as a whole.[16]

.38 The auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Relating the risks of material misstatement due to fraud to the individual accounts, classes of transactions, and assertions will assist the auditor in subsequently designing appropriate auditing procedures.

.39 Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. For example, liabilities resulting from a restructuring may be deemed to have high inherent risk because of the high degree of subjectivity and management judgment involved in their estimation. Similarly, revenues for software developers may be deemed to have high inherent risk because of the complex accounting principles

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[16] Section 312.16 provides guidance on the auditor's consideration of the extent to which auditing procedures should be performed at selected locations or components. [Footnote revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107. Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

applicable to the recognition and measurement of software revenue transactions. Assets resulting from investing activities may be deemed to have high inherent risk because of the subjectivity and management judgment involved in estimating fair values of those investments.

.40 In summary, the identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:

- The *type* of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets
- The *significance* of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements
- The *likelihood* of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements[17]
- The *pervasiveness* of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

.41 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph .54 for examples of auditing procedures related to the risk of improper revenue recognition.)[18]

A Consideration of the Risk of Management Override of Controls

.42 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57) apart from any conclusions regarding the existence of more specifically identifiable risks.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.43 Section 314 requires the auditor to obtain an understanding of each of the five components of internal control sufficient to plan the audit. It also notes

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[17] The occurrence of material misstatements of financial statements due to fraud is relatively infrequent in relation to the total population of published financial statements. However, the auditor should not use this as a basis to conclude that one or more risks of a material misstatement due to fraud are not present in a particular entity. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[18] For a discussion of indicators of improper revenue recognition and common techniques for overstating revenue and illustrative audit procedures, see the AICPA Audit Guide *Auditing Revenue in Certain Industries*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

that such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, design tests of controls when applicable, and design substantive tests. Additionally, section 314 notes that controls, whether manual or automated, can be circumvented by collusion of two or more people or inappropriate management override of internal control. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

.44 As part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation.[19] These programs and controls may involve (*a*) specific controls designed to mitigate specific risks of fraud—for example, controls to address specific assets susceptible to misappropriation, and (*b*) broader programs designed to prevent, deter, and detect fraud—for example, programs to promote a culture of honesty and ethical behavior. The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks (see paragraph .80). The exhibit at the end of this section [paragraph .88] discusses examples of programs and controls an entity might implement to create a culture of honesty and ethical behavior, and that help to prevent, deter, and detect fraud.

.45 After the auditor has evaluated whether the entity's programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud (see paragraphs .46 through .67).[20]

Responding to the Results of the Assessment[21]

.46 The auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence. As noted in paragraph .13, professional skepticism is an attitude that includes a critical assessment of the competency and sufficiency of audit evidence. Examples of the application of professional skepticism in response to the risks of material misstatement due to fraud are (*a*) designing additional or different auditing procedures to obtain more reliable evidence in support of specified financial statement account balances, classes of transactions, and related assertions, and (*b*) obtaining additional corroboration of management's explanations or representations concerning material matters, such as through third-party confirmation, the use of a specialist, analytical procedures, examination of documentation from independent sources, or inquiries of others within or outside the entity.

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[19] See footnote 10. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[20] Notwithstanding that the auditor assesses identified risks of material misstatement due to fraud, the assessment need not encompass an overall judgment about whether risk for the entity is classified as *high*, *medium*, or *low* because such a judgment is too broad to be useful in developing the auditor's response described in paragraphs .46 through .67. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[21] Section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires the auditor to determine overall responses and design and perform further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit. See paragraphs .04 and .07 of section 318. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 2006, by Statement on Auditing Standards No. 113.]

.47 The auditor's response to the assessment of the risks of material misstatement of the financial statements due to fraud is influenced by the nature and significance of the risks identified as being present (paragraphs .35 through .42) and the entity's programs and controls that address these identified risks (paragraphs .43 through .45).

.48 The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph .50).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51 through .56).

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs .57 through .67).

.49 The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action (see paragraph .78).

Overall Responses to the Risk of Material Misstatement

.50 Judgments about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

- *Assignment of personnel and supervision.* The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement (see section 210, *Training and Proficiency of the Independent Auditor*, paragraph .03). For example, the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology (IT) specialists, or by assigning more experienced personnel to the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud (see section 311.28).

- *Accounting principles.* The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements. In developing judgments about the quality of such principles (see section 380, *The Auditor's Communication With Those Charged With Governance*, paragraph .11), the auditor should consider whether their collective application indicates a bias that may create such a material misstatement of the financial statements.

- *Predictability of auditing procedures.* The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed—for example, performing substantive tests of selected account balances and assertions not otherwise tested due to their materiality or risk, adjusting the timing of testing from that otherwise expected, using differing sampling methods, and performing procedures at different locations or at locations on an unannounced basis.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 108. Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

.51 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. However, because management may have the ability to override controls that otherwise appear to be operating effectively (see paragraph .08), it is unlikely that audit risk can be reduced to an appropriately low level by performing only tests of controls.

.52 The auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures in the following ways:

- The *nature* of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity, such as public-record information about the existence and nature of key customers, vendors, or counterparties in a major transaction. Also, physical observation or inspection of certain assets may become more important (see section 326, *Audit Evidence*, paragraphs .06 through .13). Furthermore, the auditor may choose to employ computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts or electronic transaction files. Finally, inquiry of additional members of management or others may be helpful in identifying issues and corroborating other audit evidence (see paragraphs .24 through .26 and paragraph .53).
- The *timing* of substantive tests may need to be modified. The auditor might conclude that substantive testing should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud (see section 318, *Performing Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*). That is, the auditor might conclude that, given the risks of intentional misstatement or manipulation, tests to extend audit conclusions from an interim date to the period-end reporting date would not be effective.

  In contrast, because an intentional misstatement—for example, a misstatement involving inappropriate revenue recognition—may have been initiated in an interim period, the auditor might elect to apply substantive tests to transactions occurring earlier in or throughout the reporting period.

- The *extent* of the procedures applied should reflect the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate (see section 350, *Audit Sampling*, paragraph .22, and section 329). Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statements on Auditing Standards No. 105, No. 106, No. 110 and No. 111.]

.53 The following are examples of modification of the nature, timing, and extent of tests in response to identified risks of material misstatements due to fraud.

- Performing procedures at locations on a surprise or unannounced basis, for example, observing inventory on unexpected dates or at unexpected locations or counting cash on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Making oral inquiries of major customers and suppliers in addition to sending written confirmations, or sending confirmation requests to a specific party within an organization.
- Performing substantive analytical procedures using disaggregated data, for example, comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations.[22]
- Interviewing personnel involved in activities in areas where a risk of material misstatement due to fraud has been identified to obtain their insights about the risk and how controls address the risk (also see paragraph .24).
- If other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work that needs to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.

Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting

.54 The following are additional examples of responses to identified risks of material misstatements relating to fraudulent financial reporting:

- *Revenue recognition.* Because revenue recognition is dependent on the particular facts and circumstances, as well as accounting principles

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[22] Section 329, *Analytical Procedures*, provides guidance on performing analytical procedures as substantive tests. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

and practices that can vary by industry, the auditor ordinarily will develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. If there is an identified risk of material misstatement due to fraud that involves improper revenue recognition, the auditor also may want to consider:

— Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.

— Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements.[23] For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

— Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.

— Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.

— For those situations for which revenue transactions are electronically initiated, authorized, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

- *Inventory quantities.* If there is an identified risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis (see paragraph .53) or to conduct inventory counts at all locations on the same date. In addition, it may be appropriate for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.

  It also may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances

[23] Section 330, *The Confirmation Process*, provides guidance about the confirmation process in audits performed in accordance with GAAS. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.[24] Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

Following the physical inventory count, the auditor may want to employ additional procedures directed at the quantities included in the priced out inventories to further test the reasonableness of the quantities counted—for example, comparison of quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records. The auditor also may consider using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

- *Management estimates*. The auditor may identify a risk of material misstatement due to fraud involving the development of management estimates. This risk may affect a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other postretirement benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. As indicated in section 342, *Auditing Accounting Estimates*, estimates are based on subjective as well as objective factors and there is a potential for bias in the subjective factors, even when management's estimation process involves competent personnel using relevant and reliable data.

  In addressing an identified risk of material misstatement due to fraud involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see section 342.09 through .14). In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of a derivative), it may be appropriate to engage a specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgments and assumptions.

  A retrospective review of similar management judgments and assumptions applied in prior periods (see paragraphs .63 through .65) may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 106.]

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[24] Section 336, *Using the Work of a Specialist*, provides guidance to an auditor who uses the work of a specialist in performing an audit in accordance with GAAS. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets

.55 The auditor may have identified a risk of material misstatement due to fraud relating to misappropriation of assets. For example, the auditor may conclude that the risk of asset misappropriation at a particular operating location is significant because a large amount of easily accessible cash is maintained at that location, or there are inventory items such as laptop computers at that location that can easily be moved and sold.

.56 The auditor's response to a risk of material misstatement due to fraud relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit responses noted in paragraphs .52 through .54 may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified. For example, if a particular asset is highly susceptible to misappropriation and a potential misstatement would be material to the financial statements, obtaining an understanding of the controls related to the prevention and detection of such misappropriation and testing the operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of such assets (for example, counting cash or securities) at or near the end of the reporting period may be appropriate. In addition, the use of substantive analytical procedures, such as the development by the auditor of an expected dollar amount at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances.

Responses to Further Address the Risk of Management Override of Controls

.57 As noted in paragraph .08, management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways. Accordingly, in addition to overall responses (paragraph .50) and responses that address specifically identified risks of material misstatement due to fraud (see paragraphs .51 through .56), the procedures described in paragraphs .58 through .67 should be performed to further address the risk of management override of controls.

.58 ***Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.*** Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (*a*) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (*b*) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements. More specifically, the auditor should:

a. Obtain an understanding of the entity's financial reporting process[25] and the controls over journal entries and other adjustments. (See paragraphs .59 and .60.)

b. Identify and select journal entries and other adjustments for testing. (See paragraph .61.)

c. Determine the timing of the testing. (See paragraph .62.)

d. Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

.59 The auditor's understanding of the entity's financial reporting process may help in identifying the type, number, and monetary value of journal entries and other adjustments that typically are made in preparing the financial statements. For example, the auditor's understanding may include the sources of significant debits and credits to an account, who can initiate entries to the general ledger or transaction processing systems, what approvals are required for such entries, and how journal entries are recorded (for example, entries may be initiated and recorded online with no physical evidence, or may be created in paper form and entered in batch mode).

.60 An entity may have implemented specific controls over journal entries and other adjustments. For example, an entity may use journal entries that are preformatted with account numbers and specific user approval criteria, and may have automated controls to generate an exception report for any entries that were unsuccessfully proposed for recording or entries that were recorded and processed outside of established parameters. The auditor should obtain an understanding of the design of such controls over journal entries and other adjustments and determine whether they are suitably designed and have been placed in operation.

.61 The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider:

- *The auditor's assessment of the risk of material misstatement due to fraud.* The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary.
- *The effectiveness of controls that have been implemented over journal entries and other adjustments.* Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of those controls. However, even though controls might be implemented and operating effectively, the auditor's

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[25] Section 314 requires the auditor to obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. This understanding includes (*a*) the procedures used to enter transaction totals into the general ledger; (*b*) the procedures used to initiate, record, and process journal entries in the general ledger; and (*c*) other procedures used to record recurring and nonrecurring adjustments to the financial statements. [Footnote revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109. Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

procedures for testing journal entries and other adjustments should include the identification and testing of specific items.

- *The entity's financial reporting process and the nature of the evidence that can be examined.* The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested.

- *The characteristics of fraudulent entries or adjustments.* Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (*a*) made to unrelated, unusual, or seldom-used accounts, (*b*) made by individuals who typically do not make journal entries, (*c*) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (*d*) made either before or during the preparation of the financial statements that do not have account numbers, or (*e*) containing round numbers or a consistent ending number.

- *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (*a*) contain transactions that are complex or unusual in nature, (*b*) contain significant estimates and period-end adjustments, (*c*) have been prone to errors in the past, (*d*) have not been reconciled on a timely basis or contain unreconciled differences, (*e*) contain intercompany transactions, or (*f*) are otherwise associated with an identified risk of material misstatement due to fraud. The auditor should recognize, however, that inappropriate journal entries and adjustments also might be made to other accounts. In audits of entities that have several locations or components, the auditor should consider the need to select journal entries from locations based on the factors set forth in section 312.16.

- *Journal entries or other adjustments processed outside the normal course of business.* Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity's internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments such as consolidating adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity's internal controls. Accordingly, the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

.62 Because fraudulent journal entries often are made at the end of a reporting period, the auditor's testing ordinarily should focus on the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor should consider whether there also is a need to test journal entries throughout the period under audit.

.63 ***Reviewing accounting estimates for biases that could result in material misstatement due to fraud.*** In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates[26] and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. As discussed in section 312.58, the auditor should consider whether differences between estimates best supported by the audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor should reconsider the estimates taken as a whole. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

.64 The auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The significant accounting estimates selected for testing should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates. This review, however, is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

.65 If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud. For example, information coming to the auditor's attention may indicate a risk that adjustments to the current-year estimates might be recorded at the instruction of management to arbitrarily achieve a specified earnings target.

.66 ***Evaluating the business rationale for significant unusual transactions.*** During the course of the audit, the auditor may become aware of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. The auditor should gain an understanding

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[26] See section 342, *Auditing Accounting Estimates*, paragraphs .02 and .16, for a definition of accounting estimates and a listing of examples. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

.67 In understanding the business rationale for the transactions, the auditor should consider:

- Whether the form of such transactions is overly complex (for example, involves multiple entities within a consolidated group or unrelated third parties).
- Whether management has discussed the nature of and accounting for such transactions with those charged with governance.
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance.
- Whether the transactions involve previously unidentified related parties[27] or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

[Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Evaluating Audit Evidence

.68 ***Assessing risks of material misstatement due to fraud throughout the audit.*** The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. Conditions may be identified during fieldwork that change or support a judgment regarding the assessment of the risks, such as the following:

- Discrepancies in the accounting records, including:
  - — Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy
  - — Unsupported or unauthorized balances or transactions
  - — Last-minute adjustments that significantly affect financial results
  - — Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
  - — Tips or complaints to the auditor about alleged fraud
- Conflicting or missing audit evidence, including:
  - — Missing documents
  - — Documents that appear to have been altered[28]

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[27] Section 334, *Related Parties*, provides guidance with respect to the identification of related-party relationships and transactions, including transactions that may be outside the ordinary course of business (see, in particular, section 334.06). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[28] As discussed in paragraph .09, auditors are not trained as or expected to be experts in the authentication of documents; however, if the auditor believes that documents may not be authentic, he or she should investigate further and consider using the work of a specialist to determine the authenticity. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

- — Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
- — Significant unexplained items on reconciliations
- — Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures (See paragraph .72.)
- — Unusual discrepancies between the entity's records and confirmation replies
- — Missing inventory or physical assets of significant magnitude
- — Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
- — Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

- Problematic or unusual relationships between the auditor and management, including:
  - — Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought[29]
  - — Undue time pressures imposed by management to resolve complex or contentious issues
  - — Complaints by management about the conduct of the audit or management intimidation of audit team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
  - — Unusual delays by the entity in providing requested information
  - — Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
  - — Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
  - — An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

.69 Evaluating whether analytical procedures performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. As discussed in paragraphs .28 through .30, the auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatement due to fraud. The auditor also should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit (see section 329) indicate a previously unrecognized risk of material misstatement due to fraud.

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[29] Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifying or disclaiming an opinion on the financial statements. (See section 508, *Reports on Audited Financial Statements*, paragraph .24.) [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

.70 If not already performed during the overall review stage of the audit, the auditor should perform analytical procedures relating to revenue, as discussed in paragraph .29, through the end of the reporting period.

.71 Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income often are particularly relevant. These might include, for example, (*a*) uncharacteristically large amounts of income being reported in the last week or two of the reporting period from unusual transactions, as well as (*b*) income that is inconsistent with trends in cash flow from operations.

.72 Some unusual or unexpected analytical relationships may have been identified and may indicate a risk of material misstatement due to fraud because management or employees generally are unable to manipulate certain information to create seemingly normal or expected relationships. Some examples are as follows:

- The relationship of net income to cash flows from operations may appear unusual because management recorded fictitious revenues and receivables but was unable to manipulate cash.
- Changes in inventory, accounts payable, sales, or cost of sales from the prior period to the current period may be inconsistent, indicating a possible employee theft of inventory, because the employee was unable to manipulate all of the related accounts.
- A comparison of the entity's profitability to industry trends, which management cannot manipulate, may indicate trends or differences for further consideration when identifying risks of material misstatement due to fraud.
- A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, may provide unexplained relationships that could indicate a possible theft of cash receipts.
- An unexpected or unexplained relationship between sales volume as determined from the accounting records and production statistics maintained by operations personnel—which may be more difficult for management to manipulate—may indicate a possible misstatement of sales.

.73 The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

.74 ***Evaluating the risks of material misstatement due to fraud at or near the date of the auditor's report.*** At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations (for example, conditions and analytical relationships noted in paragraphs .69 through .73) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. This evaluation primarily is a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.[30]

.75 ***Responding to misstatements that may be the result of fraud.*** When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud.[31] That determination affects the auditor's evaluation of materiality and the related responses necessary as a result of that evaluation.[32]

.76 If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a nonmanagement employee.[33] Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management.[34] In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions and (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

.77 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[35]

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[30] To accomplish this communication, the auditor with final responsibility for the audit may want to arrange another discussion among audit team members about the risks of material misstatement due to fraud (see paragraphs .14 through .18). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[31] See footnote 4. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[32] Section 312.60 states in part, "Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material." Section 312.59 states, "As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." [Footnote revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107. Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[33] However, see paragraphs .79 through .82 of this section for a discussion of the auditor's communication responsibilities. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[34] Section 312.10 states that there is a distinction between the auditor's response to detected misstatements due to error and those due to fraud. When fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit. [Footnote revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107. Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[35] See section 508 for guidance on auditors' reports issued in connection with audits of financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

b. Consider the implications for other aspects of the audit (see paragraph .76).

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance.[36]

d. If appropriate, suggest that the client consult with legal counsel.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105. Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.78 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance.[37] Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (*a*) the implications about the integrity of management and (*b*) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not possible to definitively describe when withdrawal is appropriate.[38] The auditor may wish to consult with legal counsel when considering withdrawal from an engagement. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others[39]

.79 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes

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[36] If the auditor believes senior management may be involved, discussion of the matter directly with those charged with governance may be appropriate. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006. Footnote revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

[37] [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006. Footnote deleted due to conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

[38] If the auditor, subsequent to the date of the report on the audited financial statements, becomes aware that facts existed at that date that might have affected the report had the auditor been aware of such facts, the auditor should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, for guidance. Furthermore, section 315, *Communications Between Predecessor and Successor Auditors*, paragraphs .21 and .22, provide guidance regarding communication with a predecessor auditor. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[39] The requirements to communicate noted in paragraphs .79 through .82 extend to any intentional misstatement of financial statements (see paragraph .03). However, the communication may use terms other than fraud—for example, irregularity, intentional misstatement, misappropriation, or defalcations—if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

a material misstatement of the financial statements should be reported directly to those charged with governance. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with them about misappropriations perpetrated by lower-level employees. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.80 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risks represent significant deficiencies or material weaknesses in the entity's internal control that should be communicated to management and those charged with governance.[40] (See section 325, *Communicating Internal Control Related Matters Identified in an Audit* , paragraph .04). The auditor also should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud (see paragraph .44) represent significant deficiencies or material weaknesses that should be communicated to management and those charged with governance. [Revised, May 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 112.]

.81 The auditor also may wish to communicate other risks of fraud identified as a result of the assessment of the risks of material misstatements due to fraud. Such a communication may be a part of an overall communication with those charged with governance of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the quality of the entity's accounting principles (see section 380.11). [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

.82 The disclosure of possible fraud to parties other than the client's senior management and those charged with governance ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose to parties outside the entity may exist:

a. To comply with certain legal and regulatory requirements[41]

b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*[42]

c. In response to a subpoena

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[40] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 112. Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[41] These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or is the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required, under certain circumstances, pursuant to Section 10A(b)1 of the Securities Exchange Act of 1934 relating to an illegal act that has a material effect on the financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

[42] Section 315 requires the specific permission of the client. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance[43]

Because potential conflicts between the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs .79 through .81 with parties outside the client. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Documenting the Auditor's Consideration of Fraud

.83 The auditor should document the following:

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed (See paragraphs .14 through .17.)
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud (See paragraphs .19 through .34.)
- Specific risks of material misstatement due to fraud that were identified (see paragraphs .35 through .45), and a description of the auditor's response to those risks (See paragraphs .46 through .56.)
- If the auditor has not identified in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion (See paragraph .41.)
- The results of the procedures performed to further address the risk of management override of controls (See paragraphs .58 through .67.)
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions (See paragraphs .68 through .73.)
- The nature of the communications about fraud made to management, those charged with governance, and others (See paragraphs .79 through .82.)

[Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

Effective Date

.84 This section is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of this section is permissible.

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[43] For example, *Government Auditing Standards* (the Yellow Book) require auditors to report fraud or illegal acts directly to parties outside the audited entity in certain circumstances. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 113, November 2006.]

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Appendix

Examples of Fraud Risk Factors

A.1 This appendix contains examples of risk factors discussed in paragraphs .31 through .33 of the section. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (*a*) incentives/pressures, (*b*) opportunities, and (*c*) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

A.2 The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- — High degree of competition or market saturation, accompanied by declining margins
- — High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- — Significant declines in customer demand and increasing business failures in either the industry or overall economy
- — Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- — Recurring negative cash flows from operations and an inability to generate cash flows from operations while reporting earnings and earnings growth
- — Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- — New accounting, statutory, or regulatory requirements

b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- — Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages

— Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures

— Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements

— Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

c. Information available indicates that management's or those charged with governance's personal financial situation is threatened by the entity's financial performance arising from the following:

— Significant financial interests in the entity

— Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow[1]

— Personal guarantees of debts of the entity

d. There is excessive pressure on management or operating personnel to meet financial targets set up by those charged with governance or management, including sales or profitability incentive goals.

Opportunities

a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

— Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm

— A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions

— Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate

— Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions

— Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist

— Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

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[1] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

b. There is ineffective monitoring of management as a result of the following:
   — Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
   — Ineffective oversight over the financial reporting process and internal control by those charged with governance

c. There is a complex or unstable organizational structure, as evidenced by the following:
   — Difficulty in determining the organization or individuals that have controlling interest in the entity
   — Overly complex organizational structure involving unusual legal entities or managerial lines of authority
   — High turnover of senior management, counsel, or board members

d. Internal control components are deficient as a result of the following:
   — Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
   — High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
   — Ineffective accounting and information systems, including situations involving significant deficiencies or material weaknesses in internal control

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by those charged with governance, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known significant deficiencies or material weaknesses in internal control on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons

- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - — Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - — Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - — Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance
  - — Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

A.3 Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

a. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

b. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- — Known or anticipated future employee layoffs
- — Recent or anticipated changes to employee compensation or benefit plans
- — Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

a. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- — Large amounts of cash on hand or processed
- — Inventory items that are small in size, of high value, or in high demand

— Easily convertible assets, such as bearer bonds, diamonds, or computer chips
— Fixed assets that are small in size, marketable, or lacking observable identification of ownership

b. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
— Inadequate segregation of duties or independent checks
— Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
— Inadequate job applicant screening of employees with access to assets
— Inadequate recordkeeping with respect to assets
— Inadequate system of authorization and approval of transactions (for example, in purchasing)
— Inadequate physical safeguards over cash, investments, inventory, or fixed assets
— Lack of complete and timely reconciliations of assets
— Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns
— Lack of mandatory vacations for employees performing key control functions
— Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
— Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets, are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

[Revised, May 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 112. Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

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Exhibit

Management Antifraud Programs and Controls

Guidance to Help Prevent, Deter, and Detect Fraud

(This exhibit is reprinted for the reader's convenience but is not an integral part of the section.)

This document is being issued jointly by the following organizations:

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Program Manager
Knowledge Management

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Preface

Some organizations have significantly lower levels of misappropriation of assets and are less susceptible to fraudulent financial reporting than other organizations because these organizations take proactive steps to prevent or deter fraud. It is only those organizations that seriously consider fraud risks and take proactive steps to create the right kind of climate to reduce its occurrence that have success in preventing fraud. This document identifies the key participants in this antifraud effort, including the board of directors, management, internal and independent auditors, and certified fraud examiners.

Management may develop and implement some of these programs and controls in response to specific identified risks of material misstatement of financial statements due to fraud. In other cases, these programs and controls may be a part of the entity's enterprise-wide risk management activities.

Management is responsible for designing and implementing systems and procedures for the prevention and detection of fraud and, along with the board of directors, for ensuring a culture and environment that promotes honesty and ethical behavior. However, because of the characteristics of fraud, a material misstatement of financial statements due to fraud may occur notwithstanding the presence of programs and controls such as those described in this document.

Introduction

Fraud can range from minor employee theft and unproductive behavior to misappropriation of assets and fraudulent financial reporting. Material financial statement fraud can have a significant adverse effect on an entity's market value, reputation, and ability to achieve its strategic objectives. A number of highly publicized cases have heightened the awareness of the effects of fraudulent financial reporting and have led many organizations to be more proactive in taking steps to prevent or deter its occurrence. Misappropriation of assets, though often not material to the financial statements, can nonetheless result in substantial losses to an entity if a dishonest employee has the incentive and opportunity to commit fraud.

The risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. However, fraud can be difficult to detect because it often involves concealment through falsification of documents or collusion among management, employees, or third parties. Therefore, it is important to place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals that they should not commit fraud because of the likelihood of detection and punishment. Moreover, prevention and deterrence measures are much less costly than the time and expense required for fraud detection and investigation.

An entity's management has both the responsibility and the means to implement measures to reduce the incidence of fraud. The measures an organization takes to prevent and deter fraud also can help create a positive workplace environment that can enhance the entity's ability to recruit and retain high-quality employees.

Research suggests that the most effective way to implement measures to reduce wrongdoing is to base them on a set of core values that are embraced by the entity. These values provide an overarching message about the key principles guiding all employees' actions. This provides a platform upon which a more detailed code of conduct can be constructed, giving more specific guidance about permitted and prohibited behavior, based on applicable laws and the organization's values. Management needs to clearly articulate that all employees will be held accountable to act within the organization's code of conduct.

This document identifies measures entities can implement to prevent, deter, and detect fraud. It discusses these measures in the context of three fundamental elements. Broadly stated, these fundamental elements are (1) create and maintain a *culture* of honesty and high ethics; (2) *evaluate* the risks of fraud and implement the processes, procedures, and controls needed to mitigate the risks and reduce the opportunities for fraud; and (3) develop an appropriate *oversight* process. Although the entire management team shares the responsibility for implementing and monitoring these activities, with oversight from the board of directors, the entity's chief executive officer (CEO) should initiate and support such measures. Without the CEO's active support, these measures are less likely to be effective.

The information presented in this document generally is applicable to entities of all sizes. However, the degree to which certain programs and controls are applied in smaller, less-complex entities and the formality of their application are likely to differ from larger organizations. For example, management of a smaller entity (or the owner of an owner-managed entity), along with those charged with governance of the financial reporting process, are responsible for creating a culture of honesty and high ethics. Management also is responsible for implementing a system of internal controls commensurate with the nature and size of the organization, but smaller entities may find that certain types of control activities are not relevant because of the involvement of and controls applied by management. However, all entities must make it clear that unethical or dishonest behavior will not be tolerated.

Creating a Culture of Honesty and High Ethics

It is the organization's responsibility to create a culture of honesty and high ethics and to clearly communicate acceptable behavior and expectations of each employee. Such a culture is rooted in a strong set of core values (or value system) that provides the foundation for employees as to how the organization conducts its business. It also allows an entity to develop an ethical framework that covers (1) fraudulent financial reporting, (2) misappropriation of assets, and (3) corruption as well as other issues.[1]

Creating a culture of honesty and high ethics should include the following.

Setting the Tone at the Top

Directors and officers of corporations set the "tone at the top" for ethical behavior within any organization. Research in moral development strongly suggests that honesty can best be reinforced when a proper example is set—sometimes referred to as the tone at the top. The management of an entity cannot act one way and expect others in the entity to behave differently.

In many cases, particularly in larger organizations, it is necessary for management to both behave ethically and openly communicate its expectations for ethical behavior because most employees are not in a position to observe management's actions. Management must show employees through its words and actions that dishonest or unethical behavior will not be tolerated, even if the result of the action benefits the entity. Moreover, it should be evident that all employees will be treated equally, regardless of their position.

For example, statements by management regarding the absolute need to meet operating and financial targets can create undue pressures that may lead employees to commit fraud to achieve them. Setting unachievable goals for employees can give them two unattractive choices: fail or cheat. In contrast, a statement from management that says, "We are aggressive in pursuing our targets, while requiring truthful financial reporting at all times," clearly indicates to employees that integrity is a requirement. This message also conveys that the entity has "zero tolerance" for unethical behavior, including fraudulent financial reporting.

The cornerstone of an effective antifraud environment is a culture with a strong value system founded on integrity. This value system often is reflected in a code of conduct.[2] The code of conduct should reflect the core values of the entity and guide employees in making appropriate decisions during their workday. The code of conduct might include such topics as ethics, confidentiality, conflicts of interest, intellectual property, sexual harassment, and fraud.[3] For a code of

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[1] Corruption includes bribery and other illegal acts.

[2] An entity's value system also could be reflected in an ethics policy, a statement of business principles, or some other concise summary of guiding principles.

[3] Although the discussion in this document focuses on fraud, the subject of fraud often is considered in the context of a broader set of principles that govern an organization. Some organizations, however, may elect to develop a fraud policy separate from an ethics policy. Specific examples of topics in a fraud policy might include a requirement to comply with all laws and regulations and explicit guidance regarding making payments to obtain contracts, holding pricing discussions with competitors, environmental discharges, relationships with vendors, and maintenance of accurate books and records.

conduct to be effective, it should be communicated to all personnel in an understandable fashion. It also should be developed in a participatory and positive manner that will result in both management and employees taking ownership of its content. Finally, the code of conduct should be included in an employee handbook or policy manual, or in some other formal document or location (for example, the entity's intranet) so it can be referred to when needed.

Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected, and preserved. For examples of codes of conduct, see Attachment 1, "AICPA 'CPA's Handbook of Fraud and Commercial Crime Prevention,' An Organizational Code of Conduct," and Attachment 2, "Financial Executives International Code of Ethics Statement" provided by Financial Executives International. In addition, visit the Institute of Management Accountant's Ethics Center at www.imanet.org for their members' standards of ethical conduct.

Creating a Positive Workplace Environment

Research results indicate that wrongdoing occurs less frequently when employees have positive feelings about an entity than when they feel abused, threatened, or ignored. Without a positive workplace environment, there are more opportunities for poor employee morale, which can affect an employee's attitude about committing fraud against an entity. Factors that detract from a positive work environment and may increase the risk of fraud include:

- Top management that does not seem to care about or reward appropriate behavior
- Negative feedback and lack of recognition for job performance
- Perceived inequities in the organization
- Autocratic rather than participative management
- Low organizational loyalty or feelings of ownership
- Unreasonable budget expectations or other financial targets
- Fear of delivering "bad news" to supervisors and/or management
- Less-than-competitive compensation
- Poor training and promotion opportunities
- Lack of clear organizational responsibilities
- Poor communication practices or methods within the organization

The entity's human resources department often is instrumental in helping to build a corporate culture and a positive work environment. Human resource professionals are responsible for implementing specific programs and initiatives, consistent with management's strategies, that can help to mitigate many of the detractors mentioned above. Mitigating factors that help create a positive work environment and reduce the risk of fraud may include:

- Recognition and reward systems that are in tandem with goals and results
- Equal employment opportunities
- Team-oriented, collaborative decision-making policies
- Professionally administered compensation programs
- Professionally administered training programs and an organizational priority of career development

Employees should be empowered to help create a positive workplace environment and support the entity's values and code of conduct. They should be given the opportunity to provide input to the development and updating of the entity's code of conduct, to ensure that it is relevant, clear, and fair. Involving employees in this fashion also may effectively contribute to the oversight of the entity's code of conduct and an environment of ethical behavior (see the section titled "Developing an Appropriate Oversight Process").

Employees should be given the means to obtain advice internally before making decisions that appear to have significant legal or ethical implications. They should also be encouraged and given the means to communicate concerns, anonymously if preferred, about potential violations of the entity's code of conduct, without fear of retribution. Many organizations have implemented a process for employees to report on a confidential basis any actual or suspected wrongdoing, or potential violations of the code of conduct or ethics policy. For example, some organizations use a telephone "hotline" that is directed to or monitored by an ethics officer, fraud officer, general counsel, internal audit director, or another trusted individual responsible for investigating and reporting incidents of fraud or illegal acts.

Hiring and Promoting Appropriate Employees

Each employee has a unique set of values and personal code of ethics. When faced with sufficient pressure and a perceived opportunity, some employees will behave dishonestly rather than face the negative consequences of honest behavior. The threshold at which dishonest behavior starts, however, will vary among individuals. If an entity is to be successful in preventing fraud, it must have effective policies that minimize the chance of hiring or promoting individuals with low levels of honesty, especially for positions of trust.

Proactive hiring and promotion procedures may include:

- Conducting background investigations on individuals being considered for employment or for promotion to a position of trust[4]
- Thoroughly checking a candidate's education, employment history, and personal references
- Periodic training of all employees about the entity's values and code of conduct, (training is addressed in the following section)
- Incorporating into regular performance reviews an evaluation of how each individual has contributed to creating an appropriate workplace environment in line with the entity's values and code of conduct
- Continuous objective evaluation of compliance with the entity's values and code of conduct, with violations being addressed immediately

Training

New employees should be trained at the time of hiring about the entity's values and its code of conduct. This training should explicitly cover expectations of all employees regarding (1) their duty to communicate certain matters; (2) a list of the types of matters, including actual or suspected fraud, to be communicated along with specific examples; and (3) information on how to communicate those matters. There also should be an affirmation from senior management regarding employee expectations and communication responsibilities. Such training should include an element of "fraud awareness," the tone of which should be

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[4] Some organizations also have considered follow-up investigations, particularly for employees in positions of trust, on a periodic basis (for example, every five years) or as circumstances dictate.

positive but nonetheless stress that fraud can be costly (and detrimental in other ways) to the entity and its employees.

In addition to training at the time of hiring, employees should receive refresher training periodically thereafter. Some organizations may consider ongoing training for certain positions, such as purchasing agents or employees with financial reporting responsibilities. Training should be specific to an employee's level within the organization, geographic location, and assigned responsibilities. For example, training for senior manager level personnel would normally be different from that of nonsupervisory employees, and training for purchasing agents would be different from that of sales representatives.

Confirmation

Management needs to clearly articulate that all employees will be held accountable to act within the entity's code of conduct. All employees within senior management and the finance function, as well as other employees in areas that might be exposed to unethical behavior (for example, procurement, sales and marketing) should be required to sign a code of conduct statement annually, at a minimum.

Requiring periodic confirmation by employees of their responsibilities will not only reinforce the policy but may also deter individuals from committing fraud and other violations and might identify problems before they become significant. Such confirmation may include statements that the individual understands the entity's expectations, has complied with the code of conduct, and is not aware of any violations of the code of conduct other than those the individual lists in his or her response. Although people with low integrity may not hesitate to sign a false confirmation, most people will want to avoid making a false statement in writing. Honest individuals are more likely to return their confirmations and to disclose what they know (including any conflicts of interest or other personal exceptions to the code of conduct). Thorough follow-up by internal auditors or others regarding nonreplies may uncover significant issues.

Discipline

The way an entity reacts to incidents of alleged or suspected fraud will send a strong deterrent message throughout the entity, helping to reduce the number of future occurrences. The following actions should be taken in response to an alleged incident of fraud:

- A thorough investigation of the incident should be conducted.[5]
- Appropriate and consistent actions should be taken against violators.
- Relevant controls should be assessed and improved.
- Communication and training should occur to reinforce the entity's values, code of conduct, and expectations.

Expectations about the consequences of committing fraud must be clearly communicated throughout the entity. For example, a strong statement from management that dishonest actions will not be tolerated, and that violators may be terminated and referred to the appropriate authorities, clearly establishes consequences and can be a valuable deterrent to wrongdoing. If wrongdoing occurs

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[5] Many entities of sufficient size are employing antifraud professionals, such as certified fraud examiners, who are responsible for resolving allegations of fraud within the organization and who also assist in the detection and deterrence of fraud. These individuals typically report their findings internally to the corporate security, legal, or internal audit departments. In other instances, such individuals may be empowered directly by the board of directors or its audit committee.

and an employee is disciplined, it can be helpful to communicate that fact, on a no-name basis, in an employee newsletter or other regular communication to employees. Seeing that other people have been disciplined for wrongdoing can be an effective deterrent, increasing the perceived likelihood of violators being caught and punished. It also can demonstrate that the entity is committed to an environment of high ethical standards and integrity.

Evaluating Antifraud Processes and Controls

Neither fraudulent financial reporting nor misappropriation of assets can occur without a perceived opportunity to commit and conceal the act. Organizations should be proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, and (3) implementing and monitoring appropriate preventive and detective internal controls and other deterrent measures.

Identifying and Measuring Fraud Risks

Management has primary responsibility for establishing and monitoring all aspects of the entity's fraud risk-assessment and prevention activities.[6] Fraud risks often are considered as part of an enterprise-wide risk management program, though they may be addressed separately.[7] The fraud risk-assessment process should consider the vulnerability of the entity to fraudulent activity (fraudulent financial reporting, misappropriation of assets, and corruption) and whether any of those exposures could result in a material misstatement of the financial statements or material loss to the organization. In identifying fraud risks, organizations should consider organizational, industry, and country-specific characteristics that influence the risk of fraud.

The nature and extent of management's risk assessment activities should be commensurate with the size of the entity and complexity of its operations. For example, the risk assessment process is likely to be less formal and less structured in smaller entities. However, management should recognize that fraud can occur in organizations of any size or type, and that almost any employee may be capable of committing fraud given the right set of circumstances. Accordingly, management should develop a heightened "fraud awareness" and an appropriate fraud risk-management program, with oversight from those charged with governance.

Mitigating Fraud Risks

It may be possible to reduce or eliminate certain fraud risks by making changes to the entity's activities and processes. An entity may choose to sell certain segments of its operations, cease doing business in certain locations, or reorganize its business processes to eliminate unacceptable risks. For example, the risk of misappropriation of funds may be reduced by implementing a central lockbox at a bank to receive payments instead of receiving money at the entity's various locations. The risk of corruption may be reduced by closely monitoring the

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[6] Management may elect to have internal audit play an active role in the development, monitoring, and ongoing assessment of the entity's fraud risk-management program. This may include an active role in the development and communication of the entity's code of conduct or ethics policy, as well as in investigating actual or alleged instances of noncompliance.

[7] Some organizations may perform a periodic self-assessment using questionnaires or other techniques to identify and measure risks. Self-assessment may be less reliable in identifying the risk of fraud due to a lack of experience with fraud (although many organizations experience some form of fraud and abuse, material financial statement fraud or misappropriation of assets is a rare event for most) and because management may be unwilling to acknowledge openly that they might commit fraud given sufficient pressure and opportunity.

entity's procurement process. The risk of financial statement fraud may be reduced by implementing shared services centers to provide accounting services to multiple segments, affiliates, or geographic locations of an entity's operations. A shared services center may be less vulnerable to influence by local operations managers and may be able to implement more extensive fraud detection measures cost-effectively.

Implementing and Monitoring Appropriate Internal Controls

Some risks are inherent in the environment of the entity, but most can be addressed with an appropriate system of internal control. Once fraud risk assessment has taken place, the entity can identify the processes, controls, and other procedures that are needed to mitigate the identified risks. Effective internal control will include a well-developed control environment, an effective and secure information system, and appropriate control and monitoring activities.[8] Because of the importance of information technology in supporting operations and the processing of transactions, management also needs to implement and maintain appropriate controls, whether automated or manual, over computer-generated information.

In particular, management should evaluate whether appropriate internal controls have been implemented in any areas management has identified as posing a higher risk of fraudulent activity, as well as controls over the entity's financial reporting process. Because fraudulent financial reporting may begin in an interim period, management also should evaluate the appropriateness of internal controls over interim financial reporting.

Fraudulent financial reporting by upper-level management typically involves override of internal controls within the financial reporting process. Because management has the ability to override controls, or to influence others to perpetrate or conceal fraud, the need for a strong value system and a culture of ethical financial reporting becomes increasingly important. This helps create an environment in which other employees will decline to participate in committing a fraud and will use established communication procedures to report any requests to commit wrongdoing. The potential for management override also increases the need for appropriate oversight measures by those charged with governance, as discussed in the following section.

Fraudulent financial reporting by lower levels of management and employees may be deterred or detected by appropriate monitoring controls, such as having higher-level managers review and evaluate the financial results reported by individual operating units or subsidiaries. Unusual fluctuations in results of particular reporting units, or the lack of expected fluctuations, may indicate potential manipulation by departmental or operating unit managers or staff.

Developing an Appropriate Oversight Process

To effectively prevent or deter fraud, an entity should have an appropriate oversight function in place. Oversight can take many forms and can be performed by many within and outside the entity, under the overall oversight of the audit committee (or those charged with governance, such as the board of directors, where no audit committee exists).

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[8] The report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework*, provides reasonable criteria for management to use in evaluating the effectiveness of the entity's system of internal control.

Audit Committee or Those Charged With Governance

The audit committee (or those charged with governance where no audit committee exists) should evaluate management's identification of fraud risks, implementation of antifraud measures, and creation of the appropriate "tone at the top." Active oversight by the audit committee can help to reinforce management's commitment to creating a culture with "zero tolerance" for fraud. An entity's audit committee also should ensure that senior management (in particular, the CEO) implements appropriate fraud deterrence and prevention measures to better protect investors, employees, and other stakeholders. The audit committee's evaluation and oversight not only helps make sure that senior management fulfills its responsibility, but also can serve as a deterrent to senior management engaging in fraudulent activity (that is, by ensuring an environment is created whereby any attempt by senior management to involve employees in committing or concealing fraud would lead promptly to reports from such employees to appropriate persons, including the audit committee).

The audit committee also plays an important role in helping those charged with governance fulfill their oversight responsibilities with respect to the entity's financial reporting process and the system of internal control.[9] In exercising this oversight responsibility, the audit committee should consider the potential for management override of controls or other inappropriate influence over the financial reporting process. For example, the audit committee may obtain from the internal auditors and independent auditors their views on management's involvement in the financial reporting process and, in particular, the ability of management to override information processed by the entity's financial reporting system (for example, the ability for management or others to initiate or record nonstandard journal entries). The audit committee also may consider reviewing the entity's reported information for reasonableness compared with prior or forecasted results, as well as with peers or industry averages. In addition, information received in communications from the independent auditors[10] can assist the audit committee in assessing the strength of the entity's internal control and the potential for fraudulent financial reporting.

As part of its oversight responsibilities, the audit committee should encourage management to provide a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud, or violations of the entity's code of conduct or ethics policy. The committee should then receive periodic reports describing the nature, status, and eventual disposition of any fraud or unethical conduct. A summary of the activity, follow-up and disposition also should be provided to all of those charged with governance.

If senior management is involved in fraud, the next layer of management may be the most likely to be aware of it. As a result, the audit committee (and others of those charged with governance) should consider establishing an open line of communication with members of management one or two levels below senior management to assist in identifying fraud at the highest levels of the

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[9] See the Report of the NACD Blue Ribbon Commission on the Audit Committee, (Washington, D.C.: National Association of Corporate Directors, 2000). For the board's role in the oversight of risk management, see Report of the NACD Blue Ribbon Commission on Risk Oversight, (Washington, D.C.: National Association of Corporate Directors, 2002).

[10] See section 325, *Communicating Internal Control Related Matters Identified in an Audit*, and section 380, *The Auditor's Communication With Those Charged With Governance*. [Footnote revised, May 2006, due to conforming changes necessary due to the issuance of Statement on Standards No. 112. Footnote revised, April 2007, due to conforming changes necessary due to the issuance of Statement on Standards No. 114.]

organization or investigating any fraudulent activity that might occur.[11] The audit committee typically has the ability and authority to investigate any alleged or suspected wrongdoing brought to its attention. Most audit committee charters empower the committee to investigate any matters within the scope of its responsibilities, and to retain legal, accounting, and other professional advisers as needed to advise the committee and assist in its investigation.

All audit committee members should be financially literate, and each committee should have at least one financial expert. The financial expert should possess:

- An understanding of generally accepted accounting principles and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. It is important for someone on the audit committee to have a working knowledge of those principles and standards.
- Experience in the preparation and/or the auditing of financial statements of an entity of similar size, scope and complexity as the entity on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller, or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in, for example, appropriate accounting estimates, accruals, and reserve provisions, and an appreciation of what is necessary to maintain a good internal control environment.
- Experience in internal governance and procedures of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee, or an external auditor responsible for reporting on the execution and results of annual audits.

Management

Management is responsible for overseeing the activities carried out by employees, and typically does so by implementing and monitoring processes and controls such as those discussed previously. However, management also may initiate, participate in, or direct the commission and concealment of a fraudulent act. Accordingly, the audit committee (or those charged with governance where no audit committee exists) has the responsibility to oversee the activities of senior management and to consider the risk of fraudulent financial reporting involving the override of internal controls or collusion (see discussion on the audit committee and board of directors above).

Public companies should include a statement in the annual report acknowledging management's responsibility for the preparation of the financial statements and for establishing and maintaining an effective system of internal control. This will help improve the public's understanding of the respective roles of management and the auditor. This statement has also been generally referred to as a "Management Report" or "Management Certificate." Such a statement can provide a convenient vehicle for management to describe the nature and manner of preparation of the financial information and the adequacy of the

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[11] *Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity, A Guide for Directors, CEOs, and Senior Managers* (1998) sets forth "basic principles" and "implementation approaches" for dealing with fraud and other illegal activity.

internal accounting controls. Logically, the statement should be presented in close proximity to the formal financial statements. For example, it could appear near the independent auditor's report, or in the financial review or management analysis section.

Internal Auditors

An effective internal audit team can be extremely helpful in performing aspects of the oversight function. Their knowledge about the entity may enable them to identify indicators that suggest fraud has been committed. The *Standards for the Professional Practice of Internal Auditing* (IIA Standards), issued by the Institute of Internal Auditors, state, "The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud." Internal auditors also have the opportunity to evaluate fraud risks and controls and to recommend action to mitigate risks and improve controls. Specifically, the IIA Standards require internal auditors to assess risks facing their organizations. This risk assessment is to serve as the basis from which audit plans are devised and against which internal controls are tested. The IIA Standards require the audit plan to be presented to and approved by the audit committee (or board of directors where no audit committee exists). The work completed as a result of the audit plan provides assurance on which management's assertion about controls can be made.

Internal audits can be both a detection and a deterrence measure. Internal auditors can assist in the deterrence of fraud by examining and evaluating the adequacy and the effectiveness of the system of internal control, commensurate with the extent of the potential exposure or risk in the various segments of the organization's operations. In carrying out this responsibility, internal auditors should, for example, determine whether:

- The organizational environment fosters control consciousness.
- Realistic organizational goals and objectives are set.
- Written policies (for example, a code of conduct) exist that describe prohibited activities and the action required whenever violations are discovered.
- Appropriate authorization policies for transactions are established and maintained.
- Policies, practices, procedures, reports, and other mechanisms are developed to monitor activities and safeguard assets, particularly in high-risk areas.
- Communication channels provide management with adequate and reliable information.
- Recommendations need to be made for the establishment or enhancement of cost-effective controls to help deter fraud.

Internal auditors may conduct proactive auditing to search for corruption, misappropriation of assets, and financial statement fraud. This may include the use of computer-assisted audit techniques to detect particular types of fraud. Internal auditors also can employ analytical and other procedures to isolate anomalies and perform detailed reviews of high-risk accounts and transactions to identify potential financial statement fraud. The internal auditors should have an independent reporting line directly to the audit committee, to enable them to express any concerns about management's commitment to appropriate internal controls or to report suspicions or allegations of fraud involving senior management.

Independent Auditors

Independent auditors can assist management and the board of directors (or audit committee) by providing an assessment of the entity's process for identifying, assessing, and responding to the risks of fraud. Those charged with governance, such as the board of directors or audit committee, should have an open and candid dialogue with the independent auditors regarding management's risk assessment process and the system of internal control. Such a dialogue should include a discussion of the susceptibility of the entity to fraudulent financial reporting and the entity's exposure to misappropriation of assets.

Certified Fraud Examiners

Certified fraud examiners may assist the audit committee and board of directors with aspects of the oversight process either directly or as part of a team of internal auditors or independent auditors. Certified fraud examiners can provide extensive knowledge and experience about fraud that may not be available within a corporation. They can provide more objective input into management's evaluation of the risk of fraud (especially fraud involving senior management, such as financial statement fraud) and the development of appropriate antifraud controls that are less vulnerable to management override. They can assist the audit committee and board of directors in evaluating the fraud risk assessment and fraud prevention measures implemented by management. Certified fraud examiners also conduct examinations to resolve allegations or suspicions of fraud, reporting either to an appropriate level of management or to the audit committee or board of directors, depending upon the nature of the issue and the level of personnel involved.

Other Information

To obtain more information on fraud and implementing antifraud programs and controls, please go to the following websites where additional materials, guidance, and tools can be found.

American Institute of Certified Public Accountants	www.aicpa.org
Association of Certified Fraud Examiners	www.cfenet.com
Financial Executives International	www.fei.org
Information Systems Audit and Control Association	www.isaca.org
The Institute of Internal Auditors	www.theiia.org
Institute of Management Accountants	www.imanet.org
National Association of Corporate Directors	www.nacdonline.org
Society for Human Resource Management	www.shrm.org

Attachment 1: AICPA "CPA's Handbook of Fraud and Commercial Crime Prevention," An Organizational Code of Conduct

The following is an example of an organizational code of conduct, which includes definitions of what is considered unacceptable, and the consequences of any breaches thereof. The specific content and areas addressed in an entity's code of conduct should be specific to that entity.

Organizational Code of Conduct

The Organization and its employees must, at all times, comply with all applicable laws and regulations. The Organization will not condone the activities of employees who achieve results through violation of the law or unethical business dealings. This includes any payments for illegal acts, indirect contributions, rebates, and bribery. The Organization does not permit any activity that fails to stand the closest possible public scrutiny.

All business conduct should be well above the minimum standards required by law. Accordingly, employees must ensure that their actions cannot be interpreted as being, in any way, in contravention of the laws and regulations governing the Organization's worldwide operations.

Employees uncertain about the application or interpretation of any legal requirements should refer the matter to their superior, who, if necessary, should seek the advice of the legal department.

General Employee Conduct

The Organization expects its employees to conduct themselves in a businesslike manner. Drinking, gambling, fighting, swearing, and similar unprofessional activities are strictly prohibited while on the job.

Employees must not engage in sexual harassment, or conduct themselves in a way that could be construed as such, for example, by using inappropriate language, keeping or posting inappropriate materials in their work area, or accessing inappropriate materials on their computer.

Conflicts of Interest

The Organization expects that employees will perform their duties conscientiously, honestly, and in accordance with the best interests of the Organization. Employees must not use their position or the knowledge gained as a result of their position for private or personal advantage. Regardless of the circumstances, if employees sense that a course of action they have pursued, are presently pursuing, or are contemplating pursuing may involve them in a conflict of interest with their employer, they should immediately communicate all the facts to their superior.

Outside Activities, Employment, and Directorships

All employees share a serious responsibility for the Organization's good public relations, especially at the community level. Their readiness to help with religious, charitable, educational, and civic activities brings credit to the Organization and is encouraged. Employees must, however, avoid acquiring any business interest or participating in any other activity outside the Organization that would, or would appear to:

- Create an excessive demand upon their time and attention, thus depriving the Organization of their best efforts on the job.
- Create a conflict of interest—an obligation, interest, or distraction—that may interfere with the independent exercise of judgment in the Organization's best interest.

Relationships With Clients and Suppliers

Employees should avoid investing in or acquiring a financial interest for their own accounts in any business organization that has a contractual relationship with the Organization, or that provides goods or services, or both to the Organization, if such investment or interest could influence or create the impression of influencing their decisions in the performance of their duties on behalf of the Organization.

Gifts, Entertainment, and Favors

Employees must not accept entertainment, gifts, or personal favors that could, in any way, influence, or appear to influence, business decisions in favor of any person or organization with whom or with which the Organization has, or is likely to have, business dealings. Similarly, employees must not accept any other preferential treatment under these circumstances because their position with the Organization might be inclined to, or be perceived to, place them under obligation.

Kickbacks and Secret Commissions

Regarding the Organization's business activities, employees may not receive payment or compensation of any kind, except as authorized under the Organization's remuneration policies. In particular, the Organization strictly prohibits the acceptance of kickbacks and secret commissions from suppliers or others. Any breach of this rule will result in immediate termination and prosecution to the fullest extent of the law.

Organization Funds and Other Assets

Employees who have access to Organization funds in any form must follow the prescribed procedures for recording, handling, and protecting money as detailed in the Organization's instructional manuals or other explanatory materials, or both. The Organization imposes strict standards to prevent fraud and dishonesty. If employees become aware of any evidence of fraud and dishonesty, they should immediately advise their superior or the Law Department so that the Organization can promptly investigate further.

When an employee's position requires spending Organization funds or incurring any reimbursable personal expenses, that individual must use good judgment on the Organization's behalf to ensure that good value is received for every expenditure.

Organization funds and all other assets of the Organization are for Organization purposes only and not for personal benefit. This includes the personal use of organizational assets, such as computers.

Organization Records and Communications

Accurate and reliable records of many kinds are necessary to meet the Organization's legal and financial obligations and to manage the affairs of the Organization. The Organization's books and records must reflect in an accurate and timely manner all business transactions. The employees responsible for accounting and recordkeeping must fully disclose and record all assets, liabilities, or both, and must exercise diligence in enforcing these requirements.

Employees must not make or engage in any false record or communication of any kind, whether internal or external, including but not limited to:

- False expense, attendance, production, financial, or similar reports and statements
- False advertising, deceptive marketing practices, or other misleading representations

Dealing With Outside People and Organizations

Employees must take care to separate their personal roles from their Organization positions when communicating on matters not involving Organization business. Employees must not use organization identification, stationery, supplies, and equipment for personal or political matters.

When communicating publicly on matters that involve Organization business, employees must not presume to speak for the Organization on any topic, unless they are certain that the views they express are those of the Organization, and it is the Organization's desire that such views be publicly disseminated.

When dealing with anyone outside the Organization, including public officials, employees must take care not to compromise the integrity or damage the reputation of either the Organization, or any outside individual, business, or government body.

Prompt Communications

In all matters relevant to customers, suppliers, government authorities, the public and others in the Organization, all employees must make every effort to achieve complete, accurate, and timely communications—responding promptly and courteously to all proper requests for information and to all complaints.

Privacy and Confidentiality

When handling financial and personal information about customers or others with whom the Organization has dealings, observe the following principles:

1. Collect, use, and retain only the personal information necessary for the Organization's business. Whenever possible, obtain any relevant information directly from the person concerned. Use only reputable and reliable sources to supplement this information.
2. Retain information only for as long as necessary or as required by law. Protect the physical security of this information.
3. Limit internal access to personal information to those with a legitimate business reason for seeking that information. Use only personal information for the purposes for which it was originally obtained. Obtain the consent of the person concerned before externally disclosing any personal information, unless legal process or contractual obligation provides otherwise.

Attachment 2: Financial Executives International Code of Ethics Statement

The mission of Financial Executives International (FEI) includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected, and preserved. This code provides principles that members are expected to adhere to and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public, and other stakeholders.

All members of FEI will:

1. Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
2. Provide constituents with information that is accurate, complete, objective, relevant, timely, and understandable.
3. Comply with rules and regulations of federal, state, provincial, and local governments, and other appropriate private and public regulatory agencies.
4. Act in good faith; responsibly; and with due care, competence, and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
5. Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
6. Share knowledge and maintain skills important and relevant to constituents' needs.
7. Proactively promote ethical behavior as a responsible partner among peers, in the work environment, and in the community.
8. Achieve responsible use of and control over all assets and resources employed or entrusted.

[Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

In the Matter Of:

Incline Village General Improvement District Board of Trustees Meeting

TRANSCRIPT OF PROCEEDINGS

July 24, 2023

Job Number: 1002369

INCLINE VILLAGE

GENERAL IMPROVEMENT DISTRICT

AUDIT COMMITTEE

TRANSCRIPT OF HEARING

AUDIT COMMITTEE MEETING

Live and Via Zoom

Held at 893 Southwood Boulevard

Incline Village, Nevada

Monday, July 24, 2023

Reported by: Brandi Ann Vianney Smith

Job Number: 1002369

A P P E A R A N C E S

COMMITTEE MEMBERS PRESENT

CHRIS NOLET, CHAIR

SARA SCHMITZ, TRUSTEE

VITO BRANDLE, MEMBER (via Zoom)

RAY TULLOCH, TRUSTEE

MICK HOMAN, MEMBER

ALSO PRESENT

JOSH NELSON, LEGAL COUNSEL

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Incline Village, Nevada - July 24, 2023 - 2:00 P.M.

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CHAIR NOLET: I'll call the meeting to order. The first order of business is roll call. I see Vito Brandle on Zoom. I'll go around the table for the rest of the Audit Committee members.

A. ROLL CALL OF THE AUDIT COMMITTEE MEMBERS

TRUSTEE TULLOCH: Present.

MEMBER BRANDLE: Here.

MEMBER HOMAN: Here.

TRUSTEE SCHMITZ: Here.

CHAIR NOLET: Okay. And I that see Josh or one of his representatives are as well. Just as a reminder, for protocol here, we're on a first-name basis. None of this Mr. or Mrs. or Chair that kind of stuff.

With that, I think we can move to the agenda. Are there any comments on the agenda? Oh, excuse me. Second outing and I made a huge mistake. We have, looks like, two.

B. PUBLIC COMMENTS

MR. FEAST: Good afternoon. My name is Bill Feast. I've spoken at a variety of Board of

Trustees meetings going back about the past year and a half with regard to a variety of matters at the tennis center and pickleball center.

I've been an owner in Incline Village for the past 15 years. Always very active in the tennis and pickleball community, my wife, myself, and my daughter. In fact, my daughter was an IVGID employee teaching children's tennis at the tennis center. So suffice to say, we've been on court probably as much or more than most owner/residents in Incline Village. It's been quite something to see the evolution of the courts and their condition over these many years that we've been playing on court.

I'd just like to say a couple of things in light of the comments I've made in the past leading up to the budget process, and that is, starting early last summer, myself the other members of the tennis-playing community, some of whom who have spoken before you before, been meeting with Sheila and members of the facility staff of IVGID management team, engineering teams, vendors that they arranged to come and inspect the courts. This has been going on since mid-last summer, so for over a year now.

So through that whole process and our committee discussions review on court of the court conditions, third-party opinions of viewing the court conditions, and doing some testing, et cetera, suffice to say that we all came to the conclusion that for a variety of reasons, not the least of which was safety, but also, certainly, quality of play and the playing experience for tennis, and that the courts have not had any major reconstruction efforts or resurfacing of any consequence since they were built in the 1970s. This is courts 1 through 7. The courts currently used for pickleball were built much, much, much later.

As highlighted in the report that was done seven years ago commissioned by the Board, all the recommendations that were made in terms of court reconstruction and stuff were not actually implemented. That's when the tennis center office and deck and all that where the restrooms were all redone. It's that report to which I'm referring.

The recommendations and guidance that was regarding court reconstruction and stuff was not completed over these past seven years since the report was done.

We understand that provisions have been

made by management staff in the budget proposals that I know you're reviewing and the full Board will be reviewing. Provisions have been made for the sums that were determined to be realistic and achievable to reconstruct courts 1 through 7 over a period of time, stretched over a period of two to three years. We would just urge that due consideration be given that -- urge that those monies that are proposed in the budget be retained and put to use.

Thank you.

MR. DOBLER: Cliff Dobler, 995 Fairway.

Last Friday on a call with Jim Bandelin regarding being denied advertising in the IVGID magazine under the claim that our village voice was political, that's untrue. Only opinions and facts are -- we engage in.

So then we discussed the debt management report and the five-year capital plan, which is on the agenda. I explained that the reports had several flaws which needed correction. I mentioned that Mr. Nolet and I had several discussions on the matter. He asked that I review the reports, give comments, and show up at the meeting. His goal was no different than mine, we want proper reporting, so here I am.

Some background -- and I think it's important to have this background -- on April 12, 2023, Granite Construction was issued a contract for phase one, which was $14 million, which included soft costs and IVGID price tag -- the price tag for the entire project was $57 million.

I realized the price tag was insufficient based on the contract, and $77 million was our guess of what I wrote the Board about of the potential shortfall.

So in May, a new estimate by Granite for the pipeline ended up to be 71.6 million, which included the soft costs.

So, in 2023, there was a budget of 14 million, and in 2024, there was a budget for 57 million, for a combined $71 million.

But the project, unfortunately, is to be done in four stages over four construction seasons or four years. Suggested that the budget be revised to reflect project estimates over the remaining four years rather than in one year, which was 2024, 14 million suggested as a right number based on the CIP report, and the remainder would be spread out over the last three years.

Ray Tulloch and Navazio was to correct the budget and bring back to the Board for approval, reflecting 14 million of pipeline and a reduction in the utility fund from 63 million to 20.7 million, or a $43 million deduction.

They came back to the Board, and the Board approved the revised budget. That went to the State on June 1st.

Now, this five-year capital plan in tonight's agenda does not reflect the final Board-approved budget. States require that the 2024 budget must match the capital plan for the same year.

Over the past month, Chris Nolet and I discovered many other items in the budget which should be amended. I met with Mr. Magee via Zoom on July 17th at 2:00 P.M. and discussed what had occurred. Other items were also discussed.

My comments on those two reports have been provided to you by email. I am available for any questions.

Thank you very much.

CHAIR NOLET: Thank you, Cliff. Bobby's going to address most all of those matters during his remarks. I think we have finally gotten to the bottom of all this, just in the nick of time. We'll get there in a few minutes.

MR. KATZ: Good afternoon. Aaron Katz, PO Box 3022. I have a written statement to be attached to the minutes of this meeting I'll be presenting.

The main reason I'm in person at this meeting is because I look forward to the presentation by Mr. Magee about this state of affairs for our senior staff that we've lost. And for those who may be watching, I'd like to review some information I put in an email to the committee that talks about all those people that we've lost.

Our GM, of course; our, what I say is an underqualified, director of finance, he did not have a CPA; our former controller, Marty Williams; our revenue manager, who left months ago, and we've apparently been unable to replace him; the addition of full-time, fully-benefited HR recruitment assistant, I don't know if that position has been filled, I suspect it hasn't, but I'm saying hasn't for purposes of this statement; our director of public works; our director of food and beverage; our sous chef, I don't know how you make a meal without a sous chef; our district clerk, who left months ago and we haven't been able to replace; and then our attorneys on top.

So that's ten key positions, and I'm sure there's another ten I don't even know about. We got a problem here when you lose that many people. And the problem's not me and it's not the nasty nine and it's not Trustee Schmitz. It goes way, way deeper, and I hope this committee will investigate into it.

I'm reminded of Reverend Jeremiah Wright. Do you remember him? He came out of the Obama era, and he had a phrase, which I think is very apt, here it's: The chickens have come home to roost.

And that's what I see happening right now. This has been going on for 50 years. It's been building all of these years from wrongs that were committed back then, and now it's all coming together to roost.

Thank you very much.

CHAIR NOLET: Just a comment to manage your expectations. Bobby's going to talk about the finance group today and the losses there and some recruitment activities that are going on. It wouldn't be fair to ask him to go beyond that, particularly since it's only in his fourth week with the District.

I know that the Board and in my part-time role, I spent some time looking at that. We have some pretty tall recruitment needs, and I'll leave it at that for now. Thank you for your comment.

Any other public comments? None online? Okay. That concludes our public comment period.

C. APPROVAL OF THE AGENDA

CHAIR NOLET: Any comments on the agenda or are we good to go?

(No comments.)

D. GENERAL BUSINESS

D 1 and D 3.

CHAIR NOLET: Okay. With that, for those of you who haven't met him, I'm going to invite Bobby Magee. He's our full-time employed interim Director of Finance, just so everyone's clear on that, to speak to item 1 of the agenda, D 1.

MR. MAGEE: I'd like to fall back on my training and say thank you, Chair Nolet and members of the committee, but I heard you say earlier that is not appropriate, and I'll certainly try to follow the lead of the agency. I will do my best to not fall back on my training.

I'd like to give a brief staffing update as to what's going on in the finance department. I've been here for just a few weeks now, as I shared with Mr. Tulloch earlier. I am able to find my office all by myself at this point, and I'm kind of proud of that. I've been trying to meet with members of the community, members of the staff, different directors and gather some opinions on what's going on in the finance department. Those have been my activities very early on, and I'm prepared to speak on some other items tonight as well as I've been bringing myself up to speed.

One of things that we have done is we've hired a temporary worker who is a retired accounting manager. I worked with her at the City of Davis, her name is Pam Day. She's absolutely fantastic and really knows her stuff. Her role here with the finance department will be to help us coordinate the audit activities, making sure that they're prepared by client list, stays on track, and that she is assisting me with proving some training to existing staff on what it is they should be doing with respect to the audit. Because, candidly, the finance team is a little green in this area, and it's something that we know we need to provide some training. And so that's what Pam will be doing.

I want to be clear that Pam is not filling the role of the controller. That position remains vacant at this time. I know there was a little bit of confusion on that, but I've asked Pam, focus on the audit, not on the controller activities, is what I've asked her to do.

She is only going to be working part time, about a maximum of 15 hours per week. We feel like that will be plenty to assist existing staff and support existing staff with what it is we're trying to accomplish with respect to the audit.

We do still have multiple vacancies we are actively recruiting for. One is the controller position. Another one is the revenue manager position. We have struggled, candidly, with getting a robust candidate pool, and I know that before I got here that some interviews were conducted, however, no offer was ultimately extended to any candidate. And I continue to work with the human resources director on figuring out ways to increase interest in those two positions.

With that, I'm happy to answer any questions.

CHAIR NOLET: Fellow committee members, any questions?

TRUSTEE TULLOCH: Are we confident we've got enough covered to pursue the audit?

MR. MAGEE: I don't know as of yet. It's
something that I'm very concerned about, candidly.
I don't know that we have enough staff, but the
bottom line is is I plan to roll up my sleeves, and
I know that the team, we have multiple people inside
of the finance department that have indicated, "I
don't feel like I have the appropriate training in
order to do these things, but I'm willing to get in
there and help out and learn because we understand
we're a little behind the 8 ball right now."

So, I think that we can get through it,
but I don't want to say yes because I don't know
that as of right now.

We are actively trying to fill these
positions to get the help that we believe we need.

TRUSTEE TULLOCH: Okay. Thank you. I'm
glad it give us the opportunity to help develop
staff so we've got a broader base as well. That's
certainly good.

I know our Director of Human Resources has
been working hard on staff development, and I think
there's a report to the Board on Wednesday night. I
think that's excellent she's got a chance to
weigh-in on that.

I think as -- having been on the Audit

Committee for the last three years, my big concern is to see that we actually, hopefully, manage to get -- to achieve a clean audit this year. That may still take some cleaning up, but certainly that would be our hope.

Please reach out to us if there is anything we can do to support.

MEMBER HOMAN: Can you just talk us through how wide are we casting the net to try to find people? I know some of these have been open for a while, what are we -- what's the issue that -- are there issues that we can address that will help us get the candidates in?

MR. MAGEE: I asked the human resources director for a meeting later this week to go over specifically these items. I can tell you that I know that we have advertised in a number of different places that financial professionals would typically be looking at. One of them is CSMFO, that's a very active -- I forget what the acronym means, but it's a municipal finance officers in California, and being right here on the border, we will get a lot of activity on that site. I know there are other sites specific to this area that have been advertised on.

However, one of the things that we discussed already was those advertisements took place some time ago, and quite often when candidates see that it's been sitting out there for a while, they feel like it may be stale and they may not apply for it thinking that we're already deep into the process.

So, we've already talked about maybe we should readvertise on that, but that's something we intend to look at later this week on brainstorming how do we increase interest in these positions and get qualified candidates to apply.

MEMBER HOMAN: Are we using any of the traditional finance recruiting search firms? Do we have budget money? If not, do we need budget money for that?

MR. MAGEE: Yeah. So, the intention, my understanding anyways, is to use a search firm for the director of finance position.

We are not going to use that unless we receive other direction from Board of Trustees to use that for the controller position or for the revenue manager position. Obviously, while we've struggle to fill that position, it's quite expensive to use a recruitment firm for that. And we believe at that level, if we continue to be diligent about it, we will be able to find qualified candidates for those two, other level positions.

The director of finance is a little more challenging, and so the intent is to use a recruiting firm for that.

MEMBER HOMAN: Just -- I would just ask that if we do continue to have problems on that controller that you think about revisiting that because that's a pretty critical role.

One final question that kind of follows up on Ray's questions about preparedness for the audit, are we talking to any of the finance temp agencies to get some people in here to help through that?

MR. MAGEE: Yeah. We have not engaged any temp agencies that I'm aware of. In my personal experience, finding someone with governmental experience is a little more of a challenge when you reach out to those types of agencies.

As some of our CPAs in the room know, there's a difference between GAAP accounting and GAAP per the GASB accounting. They're different. And when you reach out to account temps or Robert Half or those type of agencies, typically they don't have anyone that has experience with understanding fund accounting and GASB requirements and those types of things.

Is there -- is the potential there? Of course. And that is one of the things that I had mentioned to the HR director. We might want to think about that and see if we can find a candidate.

I have reached out to -- I'm a professional consult, I've been doing this for ten years now. I've reached out to a lot of my consulting friends. I have not identified anybody that has capacity or is available right now. But I've personally reached out, and we will continue to do so because we know these roles need to be filled.

TRUSTEE SCHMITZ: Just to follow up on that, as you're looking at recruiting and you're thinking about staffing, it's a significant amount of accounting staff.

Have you considered the acceptability or the possibility that this department could, potentially, be remote and work remotely? And if they need to be a team and work in one physical location, have we at all thought about, potentially, have a remote IVGID accounting department that, maybe, is housed in Reno or someplace?

It's difficult for us to get people who

oftentimes have to drive over the hill in the wintertime.

From my perspective, I would like you to be as open-minded as possible and come forward with ideas that you think might work for overcoming the staffing challenges that we're encountering.

MR. MAGEE: Thank you for those comments. That is something that I've been advocating since pre-COVID, actually, is that -- as we first moved into COVID, I was consulting for another city, and I had made a suggestion to that particular city manager that we looked at it very closely because we just didn't know at that time where COVID was going to take us.

And I told him that we had done some contingency planning, and we came to the conclusion that our department believed that a finance department could essentially work a hundred percent remote.

And I know that that's ultimately a policy decision that the Board would have to make, but at the same time, that is my personal belief that could work.

It's really a management issue. If management is staying on top of these things to ensure that the work is getting completed, on time, and people have a the ability to be professionals and work from home, it is absolutely something that I personally would recommend that the District considers. I think it would certainly open the candidate pool if they had that opportunity.

TRUSTEE TULLOCH: Another thought. One thing I was quite surprised at when I looked at the adverts for the controller, you know, the remuneration level there seemed quite a gulf from the finance director. It seemed to be, to me, it's -- people may be surprised to hear me say that.

But, yeah, it seemed to be almost underpriced.

MR. MAGEE: Um-hmm.

TRUSTEE TULLOCH: Because basically the controller should, ideally, be the finance-director-in-waiting here or the stand-in or the standby. I've spoken with Director Feore about this as well.

Another thought was, given typically in the finance director job, you get a lot of people that are not really totally qualified for it yet or not really at the stage of their career where they're ready for it, but we should be reviewing the candidates there as well to see whether any of them could be slotted in as controller and a chance to build their resume and build up their capabilities.

MR. MAGEE: Sure.

For obvious reasons, I'm not privy to any of the activities related to the finance director recruitment, but I have shared with the human resources director that, if she wishes to engage me in assisting her with that, I would be happy to do so. But, to date, I haven't been too involved in that particular part of the process.

But, yes, I certainly understand your point, and it's well taken.

CHAIR NOLET: If there are no other comments, I'll close this section out.

MR. NELSON: Chair, Vito had his hand up.

MEMBER BRANDLE: I'll jump in, Chris. Real quick, on the element -- and this kind of goes a little bit to what Mick was saying before -- if we're not going to, kind of, explore some of the -- or at least right now, explore some of these third-party opportunities, it seems to me that there's probably a pretty serious risk, if this is slow to hire, there are going to be ripple effects for the rest of the reporting that we have to do in general.

Is there a contingency plan in place if we aren't able to hire these folks and we just don't have the bandwidth or the skill sets in-house to get some of this done?

MR. MAGEE: Yeah. Thank you. I appreciate that question for sure because -- to answer the question, there is no contingency plan in place right now that I'm aware of. It is something that concerns me, and I have been thinking about it.

You're absolutely correct, this is why, during my interview process, and I interviewed with Chris during the interview, I had mentioned to him that it was a great concern. And I was asked, what types of resources do you think you would need? And I suggested bringing on Pam Day immediately. And I think that, as we move through this, we are having a meeting with Pam and our senior accountant tomorrow to talk about workload and to see, do we think we can keep up with this?

Because, candidly, we've got to get the year-end books closed and start working towards a trial balance right away. And that's incumbent upon me to make sure that process is happening and it's staying on track.

And if I find that I need more resources, I will certainly be going to the General Manager and making some recommendations on how do we keep this thing on track, because I do not want this falling behind.

CHAIR NOLET: If I can close this topic. I think your mic still may be on, Bobby.

Anyway, those were all good comments. As I'm apt to do from time to time and stray from the narrow charter of 15.1.0, I've been having conversations with Erin and Paul going back into late April or early May on this topic.

A couple things to note. I do think our adverts, as you would say, have been a little modest thus far, and I've talked to Erin about putting a little punch and spark into them. I think she's working on that. I know they're working on the job description for the GM, and I think we'll see some of that.

I do think the salary levels are low. This is a chance for us to upgrade, and I don't think it's going to cost us a ton of money to do so. I have spent time with many people suggesting the GM salary needs to go up. The director of finance salary needs to go up, the controller salary needs to go up. We'll see where those go.

The only contingencies plan, Vito, that we have at this point, we do have a local resource, who some of us interviewed. I think you've -- we have talked about him, you have not interviewed him, Nolan Umura (phonetic). He's not ideal. He's a very experienced finance executive, maybe 40 years old, ish. He could be a great -- he lives down the street, he's between projects, he might be great.

The reason we set the agenda with this discussion first, and then we can hear from Jennifer who's on the other side looking at the glass half full, is to see whether we need to exercise that one.

I think we can enhance our contingency plan. But the key's really going to be recruiting and, frankly, if I were a controller candidate, I wouldn't have been very interested in a position interviewing with someone who is three weeks and gone. I don't think that helped either. We'll have some fresh legs in the running here pretty quick.

Any other comments on this topic? Close out D 1.

D 3.

CHAIR NOLET: Jennifer, you're up.

JENNIFER: My area that I'm planing to cover for you today is to go over an update on the audit, and I'll let you know where we are in the process.

We have started the preliminary stage of the audit or the planning process. We had the week of June 12th dedicated to work on the interim audit, is what we call it. And I would say we got done maybe about half of what we were hopping to get done, and a lot of that had to do with Marty's position being vacant at that time, and we just got off to a slow start in terms of the items that were requested to review. So, we will be putting in additional time to wrap up some of the interim audit work.

But we did perform some planning, we looked at internal controls, did some transaction sampling, and then we performed an inventory observation at the Pro Shop, right around the fiscal year end.

For the final audit fieldwork, we're currently scheduled to start the final audit in early October. And we anticipate the audit is going to be a little more complex this year, for some of the reasons you've already discussed. We --

basically the change in the finance staff at the higher levels has, historically with other clients, resulted in some difficulties because there's a bit of a learning curve of getting up to speed on the information that we need for the audit. I'm so happy that Bobby is on board to help with that process.

Also, with the implementation of the new accounting system, there's going to be some other complexities to the audit this year that would not have been present in the past.

And, lastly, the requirement to perform a single audit this year on the SRF loans is something that we have not had to audit in the past.

What's nice about the single audit is it's not due to the federal oversight agencies until March of the following year. So, if needed, we can prioritize the financial statement audit first and get that finalized and then do the single audit afterwards. That's not an uncommon practice to do that, which would, maybe, result in the single audit fieldwork happening around the January timeframe after the audit's completed.

So kind of what we owe to you right now is we need to work with Bobby to come up with a work plan for the audit in terms of the milestones and deadlines and walking through the timing of draft reports, and then we can communicate that with you and get your input on that timing.

We've had some preliminary discussions with Bobby about whether or not October is reasonable to get started on the audit, and he seems to be fairly confident that we can do that. So, I'll just let you know that we're committed on our end to get the work done.

The big question mark is how long the finance staff will need to close the books and make the changes and have the audit request list information available to us. Which is a question I can't really answer, and we might just have to wait and see how the year-end process goes.

So, that's all of the prepared comments I had for you in terms of where we are in the audit process. We're just getting started and hopeful that the year-end close goes well.

CHAIR NOLET: Thanks, Jennifer. We'll have a couple of questions here.

MEMBER HOMAN: Just a question for clarification: The October timing, is that driven more by when we're going to have stuff available or by, Jennifer, your availability to come in and do the work?

JENNIFER: It's driven by when you will be available. It was something we discussed with Paul before he left, about the timing of -- based on Mary's departure, of when he thought he would reasonably be ready for the audit.

So, we have not revised that timing yet, and that's really for Bobby to evaluate whether or not that's still reasonable.

MR. MAGEE: We started discussing that today, actually. I sat down with the team earlier today and started discussing the process for the year-end close and the types of activities that we need to undertake.

Let the cat a little out of the bag, I intend to address that at our director's meeting tomorrow about when we need to make sure everything is in to the finance department so that we can complete that process and make sure everything has stayed on track. And the importance of making sure that we have everything we need from the departments in the way of invoices and other types of activities that may be going on out there that we're just not aware of.

As of right now, we believe that timeframe is still doable. I think it's likely to get pushed a little bit, but we do have a -- my understanding is, statutorily, we have a deadline of December 31st, and I absolutely believe that we can hit that as of right now; however, we're trying to get ahead of the game, and that's why we suggested the October timeframe.

So, if that slips a little bit, we'll be okay. If it starts slipping too much, that is when I'm going to come back with some recommendations on how we get it back on track.

MEMBER HOMAN: Thanks. Just a couple of observations/recommendations, maybe. Given that we -- I mean, Jennifer, to your point that any time there's this amount of turnover, we expect some inefficiencies.

We ought to, maybe, think through are there pieces that we can complete before then so that Jennifer and her team can do some work on the audit in advance to try to get some of the stuff knocked out of the way so that we don't run into issues.

Anything that we can do along that way, be creative, so that we don't have to expect everything to be done before we get started would be helpful.

Another observation -- and maybe this is more for Bobby, for you, for Ray, for Sarah -- I'm just -- the fact that it takes us three full months to close the books, I think we all ought to view that as unacceptable. And we clearly don't -- Bobby, you've got a lot of experience and you can help here, I think -- have others internally that are probably qualified to do the type of change management that we're going to need to think through, how do we do this better? There's got to be a ton of examples out there. I'm sure there are firms out there that could come in, take a look at what we're doing, map it all out, and there's got to be a lot of low-hanging fruit out there that would help us make some pretty significant strides here.

It might require we get some budget money to fund it, but that would be so well spent if we do that. I just think three months is -- we just can't live with that.

TRUSTEE SCHMITZ: I think that's necessary, because we have had, year after year, where the audit report comes before the Audit Committee, the Audit Committee doesn't have sufficient time to complete their assessment and their recommendation to the Board.

The timeframe for submitting to the State is not December 31st; it's January 31st, unless I'm mistaken. But it's January 31st. The governing board does have 30 days from the time that they receive the report to actually have to submit it to the State by January 31st.

And we've just got to figure out a timeline that allows the Audit Committee sufficient time to do their work and to formulate a comprehensive report to the Board of Trustees for at that time when the Board gets the ACFR (phonetic) to have the Audit Committee report and have time to digest it themselves.

So, we really need to -- this has been an issue year after year, and I would like to -- I understand we a lot of challenges, but we need to either recognize there's a timetable that's needed at the end or we need to be willing to accept that we're going to ask for an extension.

MR. MAGEE: There's a couple of points there I'd like to address.

Being right here on the border, I know things kind of blend into each other sometimes. In the State of California, it is -- I am a hundred

percent certain that the statutory deadline is
January 31st.
When I was speaking, Jennifer, with your
firm the other day, thought they had mentioned it
was December 31st. Is the statutory deadline
December or January 31st?
JENNIFER: For the State reporting, it's
January 31st.
MR. MAGEE: Wonderful. That's even
better.
One of the things to your point and to
your point is that, to my knowledge, this agency
does not have an year-of-year audit calendar that
I've been able to locate at least. That is one of
the things that Pam and I have already discussed,
that we need to do this, we need to have something
that explains to staff throughout the agency that
these are the steps and the deadlines for each one
of these things to make sure that these things are
staying on track. And, to my knowledge, that
doesn't exist right now.
So, that was one of the very first
assignments that had I gave to Pam, to start working
with the senior auditor, and then I will be involved
too as we go through the process in developing this

audit calendar. We can certainly bring it to this
committee if you want to take a look at it and let
you know what type of activities we're looking at.

I have not found one. If one exists, I'd
love to see it, if anybody knows where that is.

TRUSTEE TULLOCH: I would concur with Mick
and Sara's comments. It's not just for the
end-of-year audit; it's for our monthly reporting.

When it's -- when we're three weeks into
the next month before we get -- see reports, it's
impossible. I couldn't run a business that way.
Last time I had to do that was probably in the 1980s
when we were still running mainframes and things.

We should be setting ourselves targets for
ten days maximum for closing, if not sooner.

So, yes, I would certainly concur with
that, I think, the idea of having an audit calendar.
And also, I'd extend that to having the monthly
reporting for all the venues and directors as well.
I would encourage that at the same time, just -- in
a similar format. I think that would be great.

My other question: Is Tyler Munis
sufficiently reliable now to be able to get the data
out or are we going to run into issues trying to get
the data out?

MR. MAGEE: I think we are going to continue to run into issues.

I met with the team today, and I asked that exact question. There are still some concerns, and my direction to the finance team today was, fix it and figure it out and figure it out now.

What I asked them to do, just today, is find out how much money we still have in the project, reach out to Tyler, let them know if we need somebody on site, whatever it is we need to do, but we have to have these things corrected because this has been going on for a year.

I've been here for three weeks, that unacceptable to me. And these things should be worked through. For me, I want them done, and I want them done now.

So, it's something we are actively engaged in at the moment because we've got to be better. We simply have to be better, and we know that.

TRUSTEE TULLOCH: Hopefully you can keep both the Board and the Audit Committee apprised on a pretty active basis on what we'll find with these.

But, yeah, having been someone who's implemented a lot of these systems, what I'm seeing is just not acceptable, and we need to make sure that Tyler has lived up to their requirements as well.

This sounds like a fairly typical IT project, unfortunately.

MEMBER HOMAN: I agree with Ray. And I want to make just a follow-up.

I think the -- I don't care whether it's December 31st or January 31st on the audit, it's not relevant. That shouldn't play at all into our timing. There's no reason we should keep these things open beyond -- we should be done within a few weeks. That is the way we ought to think. We can't think months; we got to think days, weeks.

Because the other thing this is doing, I mean, to the extent that this drags out, it just gets in the way of everything else. It gets in the way of the budgeting calendar. It gets in the way, more importantly, to business management, people being able to make decisions.

So, we just need to abandon the old thinking altogether and start fresh and think about what's possible and what do we need to run the business.

And those timelines that are out, they're there from the stone age. They just -- they're not relevant in today's environment anymore. You know that. I'm just preaching to the choir.

CHAIR NOLET: If there are no other comments, I can close this topic out with a few observations.

We do need a closing schedule, one for each month, one for quarter end, and one for year end. And I'm confident that what you described doesn't exist here because that's just not part our historical finance DNA. We'll need those.

I agree with all the comments that were made. I would just temper expectations that if you think about the resource conversation we had, this may be the year that we at least have likely any probability of improving our timing.

Then, lastly, I just want to manage expectations.

So, Jennifer, hold on here. I wouldn't be surprised if the audit's late, and with the lack of staff we enjoyed certainly in the fourth quarter and at June 30, I couldn't possibly see how we won't have more internal control findings than we've had in prior years.

Just putting it out there, managing everybody's expectations. It's inconceivable -- and

I think Jennifer said there were a number of
challenges. You put in the lack of people in key
positions to create segregation of duties, pile on
top of that a system that's not really fully
operational yet, the internal control observations
that they provide to us were going to be very
constructive, but I'm sure going to be numerous and
substantive.

Anyway, any other comments?

TRUSTEE TULLOCH: I echo that and echo
Mick's comments. I think it's -- the closing
scheduled should be set by how we need to run the
business. That's key. We're running commercial
businesses, we need to -- you need to get the data
quickly. We can't do -- run it otherwise.

I think in -- yeah, I think it's fair to
expect that this could be a transition year, but it
doesn't mean we set ourselves targets. Maybe we'll
get some findings out of that to improve process,
but, yeah, I accept there's going to be challenges,
but we should still push for it.

Thank you.

TRUSTEE SCHMITZ: Just to follow up on
that, you talked about that Pam Day was here doing
training. I certainly hope that while she's doing

the training, there's documentation that is being created so that we -- we're capturing how things need to be done for the future.

MR. MAGEE: Yes. That is, additionally, some of the direction I provided to staff.

So when I first got here, the very first week I was here, I shared with staff that I want every one of the finance staff to be cross-trained on something. There is something in this department that interests you.

If any given person leaves or is out of the office for a couple weeks on vacation, whatever it is, somebody knows how to pick it up and run with.

And part of that process is documenting this type of stuff so that if somebody were to be out of an extended period of time, someone else could look at the documentation, and they might have to fumble their way through it, but they could do it and they could figure it out so that we don't find ourselves in this type of position in the future.

I believe the auditors will tell you, when you have this type of turnover in a finance department, it is risk to the agency. And that's one of the things that I'm trying to do through this process is mitigate that risk moving forward.

CHAIR NOLET: I think that closes out D 3, which I subtly grouped with D 1 because they went together. I apologize.

Jennifer, any other comments from you before we move on?

JENNIFER: No. Thank you. And I anticipate -- if we need to schedule additional Audit Committee meetings during the year because of the complexities this year, I'm happy to attend any meetings that you request me at.

CHAIR NOLET: Thank you.

That takes us back to D 2.

D 2.

CHAIR NOLET: I'll just open this up, review and consider, for Board approval this Wednesday, a revised five-year capital plan.

This topic has gotten an immense amount of focus in the last month. Bobby's, I'm sure, already having nightmares about the five-year capital plan.

It's something that was brought before the Board on May 25th. And for those of you who recall, to oversimplify the outcome of that, there were already some concerns that there were probably errors or revisions required for the five-year capital plan.

There was a vote taken, it wasn't approved, and the marching orders were, with regard to the budget, Ray, why don't you and Paul go figure this stuff out and bring us something back we can approve.

So that exercise happened. There were material revisions to the budget. It was submitted on or about June 1st, it's on the website, it's in the State website.

We'll come back to that. That's probably going to need some revision in a couple weeks, but not a topic for today.

However, the five-year capital plan also, I think, needs revision. Bobby's been a good alterego for us. We've had a lot of back and forth on this. We've checked with the FASB, we've checked with KPMG, we've talked to a lot of people.

And I'm going to ask you to give a compact summary.

But we expect that we'll have something that's materially correct for the Board to consider on Wednesday night.

MR. MAGEE: I will say that over the last week, week and a half, we've had some rather spirited discussions, I would say, between myself and Chris. I met with Cliff Dobler, as he mentioned, previously. And while the conversations can be spirited at times, I will say that we all had the same goal, which is we want to get it right. That is what is most important.

And I've shared with Chris on a number of occasions, I'm willing to be wrong, and I don't want to be right, I want to get it right.

And so we do have some revisions -- some suggested revisions -- let me rephrase that: Some recommended revisions to the report that you see before you today based on information we got today at noon from the Department of Taxation.

As you all know, this process is a lot of staff work over several months, and this was done and put together by the previous finance director. He presented this at the Board of Trustees meeting. That was a split vote, and it was kicked back to staff. They suggested that the chair of the Audit Committee take a look at this, so I've been working with him.

Paul Navazio went back in and made the requested revisions to the report that were requested by the Board. I personally went in and

reviewed that file and saw every single one of those
things had been updated. And then Mr. Dobler noted
that all of those things haven't been done. And so
I wanted to point out that I was really scratching
my head when I saw his comments.
I went back in there today, and I noted
that there were a couple of things on there that
appear that had not been done, although I personally
verified that each one of them was after Mr. Navazio
had told me. So, I think we had a version control
issue.
CHAIR NOLET: Just to be clear, you're
still speaking about the budget; right?
MR. MAGEE: I am speaking specifically
about the indebtedness report and the five-year CIP
comments, yes. And I understand, focused on those
two reports and what needs to go into the State.
I will note that the revisions that needed
to be made was on the five-year capital improvement
plan on page 1, the number should have been 550,000,
not 55,000, that is on page 28 of 57 in your packet.
And so on that report, you will note that on the
general fund fiscal year '25/'26, that number has
been changed to 550,000, that's on the five-year
capital improvement plan.

On the previous -- what was previously page 153, the outstanding debt as of June 30th, 2022, that is on page 8 of this particular packet. And you will note on page 8, that was not corrected here. That was corrected on the Board of Trustees' form. Just the timing of it, I did catch that one, and I did update that one for the Wednesday meeting.

And then on page 155 of the original plan -- the original document, which is page 12 of your document today, that should have read: The capital plan contemplates additional debt financing.

That was originally put in, and I believe due to version control issues, it is shown as: The capital plan contemplates debt financing.

And it does not say "additional plan" in today's file. However, I will note that that's not part of the documentation that goes to the State, I believe. Although we can -- you know what, I'm not sure if that form -- I'd have to double check on that one because this is the indebtedness report, and I don't know if it's just the schedule of all this narrative goes. I just don't have a handle on that yet. If it is, I will make sure that that correction is made prior to submitting it to the State. I'll double check with the Department of

Taxation on that one.

On page 157 of the original report, which is page 14 here, under clean water, that should have read April 14th, 2023, not 2022. That is noted. That one definitely needs to be corrected prior to submission. I will make sure that that is corrected.

And then on page 164 and 165 of the original report, which begins on page 21 of this packet, there was some discussion about the heading using "original value," and the request was to change that to "principle value," which I have confirmed that has been done in each one of the pages in this particular report. That's been updated to show "principle value."

There was a couple of other things that Mr. Dobler pointed out to me, and we did get those corrected. On page 5 of the staff report, it incorrectly identified the close of fiscal year is June 31st. Obviously, there's not 31 days in June, so we did get that one corrected.

And then there was, on page 8 of this report, on the business impacts attachments, this form that you have today incorrectly identifies the reconciliation of the five-year capital plan and carryforward. That was corrected on the Board of Trustees' form that you'll see on Wednesday. So just due to timing of when the agenda needs to be published, we caught that after the fact. So for today's discussion, it's showing as incorrectly on the Audit Committee. Just to inform all of you that we have seen that, we have caught that, that has been corrected for the Board of Trustees' package.

TRUSTEE TULLOCH: Is that corrected in the package that we've been issued or is there another update to come?

MR. MAGEE: My understand is is that was corrected on the existing one. If it's not, I'll double check and follow up on that. I believe it was.

CHAIR NOLET: I'm taking a few notes, so I may have missed this. Did you get to the penultimate revision that's required yet? The five-year capital plan, the spend by year?

MR. MAGEE: Are you referring to --

CHAIR NOLET: Page 7. The topic we've been talking about for a couple weeks here. What the State confirmed to you today.

MR. MAGEE: Oh, yes. Yeah. And I did want to walk you through that. If I can actually take you to page 28 of 57, because that is the form, NVTC-LGF-11. This is the one form that will be submitted to the State.

And so in the center of the page there, under utility fund, there is an item entitled "Capital Improvement, Five-Year Capital Improvement Plan." That amount that is in there shows a figure of $63,745,000 in today's packet. This is where a lot of the discussion centered around on what was the correct number to put in there.

I reached out to the Department of Taxation, shared this with Chris, I was calling them daily leaving them messages. I called them and left over six messages and never got a single phone call back. It was getting quite frustrating.

I finally started reaching out to some of our fellow agencies, talking to other finance directors to see, how do you handle this?

They agreed with Paul Navazio's interpretation of the guidance, which I agreed with when I read the guidance, that the $63,745,000 figure was the correct figure because that was the fully-appropriated amount that was approved by the Board for the project in this fiscal year.

Now, the problem with that is is as you

spread this out over four years, as Mr. Nolet and Mr. Dobler correctly pointed out, is you're only going to spend a portion of that. It's going to be spent over four years, so that number is incorrect the way that that's reported in there.

And I couldn't get around the fact that the Board had appropriated the full amount of the project, even though we know we're only going to spend a portion of that.

And so I kept reaching out, repeatedly, to the Department of Taxation trying to get some guidance on what the heck does this -- these instructions on this form actually mean? I understand every word. I'm struggling to understand what it is you're trying to communicate to me.

So, I reached out and finally was able to get ahold of a budget analyst with the Department of Taxation today, about noon, and she said this is a very, very common misconception and many, many agencies are putting in the full appropriation amount, and she said that is the belief that is out there.

However, that is not what they want. So I want to make a recommendation to this committee today that these plans, as they sit here, you know, with the revisions that I went through just a minute ago as well as this, this is the recommended staff action that we're requesting this committee recommend to the full Board. Okay?

The exception is is on this five-year capital plan, based on the new information received today, we're requesting that number be recommended to be changed from 63,745,000 to the number which is on the cash flow statements, which is 20,745,000, which is an amount that we believe will be expended in this particular fiscal year.

And that is the guidance that we received from the Department of Taxation, just at noon today.

With that, happy to answer any questions.

CHAIR NOLET: The remainder of the project costs will be spread over future years at they're expected to be incurred?

MR. MAGEE: That is correct. And so I specifically asked that question about the line below it that says "carryforward from prior years," and the direction I received from the Department of Taxation today was that should not be shown in future years, even though the Board fully appropriated it.

What they want to see is in year one of

any given one of these years, as those columns obviously move to the left, how are you going to spend on this fiscal year, and that's the amount that should be shown on each year.

CHAIR NOLET: And I think the key -- there are many good reasons to do it that way, notwithstanding what must be practiced out there -- is that current year of the five-year capital plan should agree to the cash flow statement in the budget. And I think we all agree with that.

That's a highly-superior way to do it versus what was done in May and April, so that is the direction we're going to go.

I don't want to truncate any other dialogue, but I know there was a little pre-meeting dialogue here, do we still have some open question as whether the number's 20 or it might be something a little different?

MR. MAGEE: Yes. I believe Mr. Dobler did an analysis, and he may have a deferring opinion. I'm happy to consider that.

CHAIR NOLET: We can sort that out in the next 24 hours. We're not going to make that sausage here. I just wanted to let people know it's either going to be 20 or something less than 20. That 20 is exactly what's in the cash flow statement in the approved budget that's been filed with the State, that number has some gravity to it already.

MR. MAGEE: That is correct.

And just to be clear, the appropriated amount is the $63 million, that is --

So, the amount on the cash flow statement is the $20,745,000, that is correct. And that has been filed with the State.

MEMBER HOMAN: The first question coming to mind is is that now going to tie to what's in the current fiscal year budget? Which it should. I don't know why we would differ from what the Board has approved, so that's good.

CHAIR NOLET: You'll hear about it Wednesday night. If it doesn't, you'll hear why it doesn't. But right now, we all -- most of us believe it should.

I have shared with a number of you before, and some others, including Michaela Tonking and folks, there are some major revisions that are needed for the budget.

So it could also be that number here, updated for fiscal '24, is 20, maybe it's a little less than 20. If we find a consensus for a better number, that could be one more revision that we'll probably make to the budget in the ensuring weeks. There's no sense of real urgency to submit an updated because it's already on file.

But we'll sort it out, so, yes, in the end, they should equal.

MR. MAGEE: And, yes, that's why I suggest that we would like for this committee to make the recommendation to the full Board, because do have a deadline for the State of August 1st. We definitely want to be in compliance with that. And if we need to make a revision later, I will certainly go back to the State and tell them we would like to file a revision.

But as of right now, I would agree with Chris that the amount is either or 20,745,000 or some amount less than that. It will not be more than that.

TRUSTEE TULLOCH: Yeah, excellent points, Chris. I'm glad we're getting closer to it because I had the same disagreement with Mr. Navazio when we filed some of the original budget numbers. Something didn't seem to make sense to me.

One concern I have is we're projecting this five-year capital plan, and I see a whole lot of items in this five-year capital plan that have never come to the Board at any stage.

I have concerns about that because we see these in the capital plan, then six months down the line when we're preparing next year's budget, we hear the claim, oh, this is in the budget so we must be going forward with that.

This is something, hopefully, we can sort out through the Capital Investment Committee as well, but it's something that concerns me. There's all sorts of money stuck in there. And it doesn't necessarily mean that they are bad ideas, but I think we need to be much more robust before anything just gets stuck in when we see seven, ten million projects stuck in there that nobody's ever heard of.

We need to make sure that we're much more mindful of what these are putting in. Because it's not -- at this stage, it's not affecting our budgeting, but it may well be pushing out much more needed projects because we suddenly find these.

I think this is my concern. It creates almost an inevitability that we need to move ahead with this because it was in the five-year plan, when it's never come to the Board.

CHAIR NOLET: To follow up on that, I've

heard that several times. It's sort of not in my short-term wheelhouse, nor of Bobby's. If you guys who know these things can just comment, -- I've heard tennis and other things -- I think that would be critical.

If you guys can't address that on Wednesday, then we don't get the August 1st date. I know it's not on the agenda right now. Just to be practical about it, if there are things in here that haven't been approved by the Board, if we don't deal with it Wednesday, we don't get the final -- we don't have a timely filing.

MEMBER HOMAN: I thought I, maybe I misread something, saw some disclosure that said that only year one has been approved by the Board. Maybe that's just the way around it that -- at least in this report, it's clear that nothing beyond year one has been approved.

TRUSTEE TULLOCH: That is correct. I've actually highlighted that part in the page here.

It's also in there to start looking at policies 12.1 and 13.1. We've got some contradictions in both of these policies in terms of some of the practices we're doing.

I think to Chris's point, it may be too

late to change this, but I think it's something we need to discuss as a board because we need to make sure we don't start raise false expectations of things, and then it becomes inevitable when it's never actually been discussed.

TRUSTEE SCHMITZ: So, I believe that I have requested that discussion to be on our long-range calendar, as a board, because we have not sat down -- and I have heard from Mr. Bandelin that staff has put together information to share with the Board on the five-year plan, but we have not received it, we have not discussed it.

And when we have constituents coming in, telling us that they have safety concerns, those things need to come to the forefront in our budgeting process. So, I think that it's really important, as a board.

But as it relates to this report, I think we just need to focus on year one, and know that the Board needs to discuss years two through five.

CHAIR NOLET: Is there anything in the year one column that's material, say over $1 million, that you don't think the Board has approved?

TRUSTEE TULLOCH: No. I think year one is good. It's in that -- in that -- end of that year is the problem is.

I think to follow up on Sara's point, when I hear stuff in public comment, oh, yes, we've agreed to staff that we'll spend this and we'll do this work in a year's time, when nothing has ever come to the Board, I think it's raising false expectations. It's been unfair to the community.

It may have been past practice, but I think it's something we need to refine. We need to make sure that we're transparent where this is coming.

TRUSTEE SCHMITZ: Then what happens when we don't discuss this, years two through five, then next year when we come to budget, it says, well, this is on our plan.

So it's something that it's been -- I feel that it's been a deficit of the Board to really talk about the long-term plan, and I think that our Investment Committee will help us, as a board, to accomplish this. And I think staff has done the work; it just hasn't been shared with the Board at a meeting.

MEMBER HOMAN: I had one other nit, it's on page 14 of the materials, and it's the clean water 2302. Your mentioned the date change. I also question why the amount outstanding exceeds the amount issued.

MR. MAGEE: Sure. I can certainly research that. That's, again, I didn't work on these reports at all. I'm happy to research it and get back to you on that one.

TRUSTEE SCHMITZ: I have a nit on page 10. Page 10, table of contents. This was pointed out with the last revision, but in the middle of the page where it's "outstanding general obligation debt as of June 22nd," it June 23rd -- 2023. I'm sorry.

MR. MAGEE: I'm going there now. I'm making some notes. On page 10?

TRUSTEE SCHMITZ: R 1. Yeah, it still says "2022," instead of 2023.

And I did find some numbers that were just off by $60,000 or something, so I will take that offline and bring those to your attention.

The only other question I have is, as it relates to this year, I believe we are intending to get a grant for the pond project. But I'm not sure I saw that reflected in here is. Is that something that is to be reflected in here?

CHAIR NOLET: Is it the $7-million grant

of which we will hope to receive 1.7 this year?
          TRUSTEE SCHMITZ: I don't know the exact
dollar amounts. I just know that staff has been
working on it, and it's for the pond project.
          CHAIR NOLET: We will follow up on that.
I think we know that, I'm just not sure we know if
it's in here or not. Good question.
          Vito?
          MEMBER BRANDLE: Yes.
          CHAIR NOLET: Let me make a suggestion.
We've got two open items on this schedule. We've
got the fiscal '24 sewer amount to be spent,
somewhere ranging between 20.5 million, and maybe as
low as 14-something.
          Bobby and I will take the action and sort
that out in the next 24 hours, and we will get help
from Cliff. So, we will sort that out. Then we
have Open Meeting Law issues, but we'll figure out a
way to communicate the outcome to you.
          And then we've got this item Sarah just
raised about the EPA grant.
          TRUSTEE SCHMITZ: It's --
          (Inaudible cross talk.)
          CHAIR NOLET: We'll figure that out. We
know what the correct number is for fiscal '24, just

don't know if it's in here or not. We'll sort that out.

I think those are our two action plans.

Then, Mike, I think that's going to put you and your team in position to get a timely filing.

Any other comments?

TRUSTEE TULLOCH: Just a quick one on the ACE grant. I don't think it will come into play in '23/'24. We won't -- it's paid in arrears. I'm not sure if it's paid in installments. If it's paid in arrears, we probably won't -- we haven't done any work in '23/'24.

CHAIR NOLET: That may be. It's in the '24 cash flow, in the final budget. And Michaela Tonking also confirmed to me that you're expecting to get a million-seven of it this year, so that's where I'm starting. We'll sort that out.

Thanks.

MR. NELSON: I was just going to mention, Chris, we can avoid any Open Meeting Law issues. Once you have resolution with Bobby, then we can just notify the Audit Committee by email. That would be permissible.

CHAIR NOLET: That closes out item D 2.

So if I can salvage any of this performance today, I think that will take us to, D 4.

D 4.

MEMBER HOMAN: The short answer to this one is there's been no progress since the last meeting.

Just a reminder of what we have done, we -- and this deals with the outstanding issues that we assumed when we moved into the Audit Committee roles from the prior Audit Committee, we have successfully put together a full inventory that was out there. We worked through the issues. We've spent -- Chris and I have spent a lot of time on this. We've had a couple meetings with Cliff Dobler and with staff, and we have resolved a number of issues.

We've got a list of about eight to ten that we're still working through. For obvious reasons, this was -- this project was tabled because of other -- both Board priorities as well as finance staff turnover.

It's tabled, but it's not dropped. We're going to get back to it. I would say that to the extent that there's anything in that -- both with respect to the things that we have resolved as well as those that are still outstanding, if there are things that will have any impact of the 2023 ACFR, we will get those resolved in time to get them reflected in the ACFR.

That's really all I had on that project.

CHAIR NOLET: Any questions, discussion?

TRUSTEE TULLOCH: Have we identified and discussed with Jennifer any of these outstanding issues or things that will impact the 2022/2023? Should we give Jennifer a heads-up?

MEMBER HOMAN: I believe that she knows we're working. We have not briefed her on any of the findings today. That will be part of what we need to do. When we reach resolution, we're going to have to run them by her and make sure that they agree with them as well. That will be part of the process.

TRUSTEE TULLOCH: I was just thinking maybe it's likely to -- if it's a 60 to 70 percent chance of something changing, just to give her a heads-up in terms of doing the audit.

CHAIR NOLET: I would just add, most of the items are look-back items. I think some of the policies have been tightened in the current fiscal year, beginning July 1 of 2022.

So, I'm hoping there aren't many that roll into the current year, but we're mindful of that, and we're thinking about that in terms of October. It's just going to have to be balanced with resources.

Okay. That takes us to item D 5.

D 5.

CHAIR NOLET: Vito, you good?

MEMBER BRANDLE: Doing great.

CHAIR NOLET: Okay. So this is the first time any Audit Committee -- IVGID's ever made this kind of a report.

We put -- the Board put a whistleblower policy into place, effectively, around the end of the year. It's been up and running. We -- the Board drove some real enhancements working with staff to that page. There's a full page. It has a link to a whistleblower form.

Everybody knows it's working because I've got plenty of whistleblower complaints. I'll just give you a summary to give you a sense for, one, we're looking at, and, two, there's no way for -- complaints go to Josh and myself, there's no way for us to respond.

So, by virtue of giving you a high-level summary, I want to acknowledge that we have your matter and we're working on it. Hopefully, you'll appreciate that.

The first one is well known to everybody. There's a concern around Trustee Dent, whether he failed to adequately disclose loans from various -- well, one person in particular, on his annual campaign disclosure forms.

Vito and I are handling that project. It's about half way done. We hope to get some real quality data in the next week around that. And I would certainly think that we'll be through that and have a viewpoint to share with the Board -- and the committee will have a viewpoint to share with the Board in August.

Of lesser importance, -- but, Mike, you ought to be listening to these -- we've got a complaint about the Mountain Course that people are playing and the staff are not decrementing their cards, so they're playing for free.

When the golfers brought this to the attention of staff, they said, "Don't worry about it, the error's in your favor."

Obviously, that's not the kind of practice we want to have at the Mountain Course, so we're following up on that.

There's a related concern around golf clubs might be getting below-stipulated green fees and may be getting too many discounts around meals. We'll sort that out.

There's a concern that -- I think this one's fairly public, so maybe I'll just mention it. There's a concern that Trustee Schmitz is buying her employee benefits from the District. It's been looked at, vetted in prior years. We're going to revet it. The concern is, maybe, there's some kind of inadvertent tax gain that her and her husband are enjoying.

I don't think that's the case. It looks like she is paying the District what she should pay, including donating her entire salary toward purchasing these benefits.

So, we'll work on that. I don't think that's going to result in any huge findings.

MR. NELSON: Chair?

CHAIR NOLET: Yes.

MR. NELSON: I apologize to interrupt. Just a reminder, the Open Meeting Law requires us to provide special interest notice of before we discuss their character or competence. And we didn't provide that notice to everyone, so it's --

CHAIR NOLET: For the individuals?

MR. NELSON: Yeah. Not discuss individual names.

CHAIR NOLET: Okay. Thank you. Good reminder.

The two last items would be there is still some rumblings around use of debit cards by Trustees. I think the staff has largely dealt with that. I'm not real current on that topic, so we have to dive into that one.

The last item is there was a formal complaint submitted about different payors associated with the District providing donations to IVCBA. We haven't started that one yet. I think we're going to make quick work of that.

Those are the matters that we've dealt with. So, we've gotten six online, and some of these will need some GC input before they come back to the committee. They're all important. We appreciate every one of them. We're going to deal with every one of them in a fulsome manner.

That's what I wanted to share with the community today.

Any questions?

TRUSTEE SCHMITZ: Josh, since my name was mentioned, am I allowed to actually provide an explanation?

MR. NELSON: You can, Trustee Schmitz. I mean, this is your voluntary choice. We have not provided you the notice that's required under the Open Meeting Law.

I would just ask that you -- if you chose to respond, you are doing so understanding you're not required to because that notice had not been provided or agendized.

TRUSTEE SCHMITZ: Okay. There's nothing inappropriate that has ever transpired. I'm purchasing at the fully-loaded burden -- the fully-loaded cost to the District, health insurance, because we are not allowed to receive any sort of benefits.

And then, I just wanted to clarify that the whistleblower had been on the Board's agenda for three years, and only this Board actually approved it in January. So, this the first year we have it in place.

TRUSTEE TULLOCH: Perhaps you can explain. I'm slightly confused. You referred to trustees have debit cards. That's something I'm not aware of. And I think before --

CHAIR NOLET: Apparently, you were left out, Ray. I'm just telling you what the complaint said. That's one we haven't delved into, so I can't add any content to that.

TRUSTEE TULLOCH: Just to clarify the record, before anyone starts making some more things like my $3 million operation at Mt. Rose, it's -- trustees don't have debit cards or procurement cards from the District. We have no financial connections like that. So, just to clarify.

MEMBER HOMAN: Just a process question. And maybe, Josh, this is directed at you. Is there -- I know we're subject to Open Meeting Laws.

I surmise or my expectation is that there will be a lot of -- while there will certainly be some substantive whistleblower things that we really need to pay attention to, I suspect that there will be a lot of frivolous stuff out there.

And I hesitate to have Chris sit up here and give us a summary of all these things that could be frivolous and could be damaging to reputations, to whatever, and be mischaracterized in the community.

So, can we, maybe at a future time, talk about a process to, you know, how we go about vetting these things and putting them into buckets on clearly frivolous, we're not even going to talk about them, and those that, maybe, this committee does need to be briefed on for whatever, for making recommendations to the Board on findings and so forth?

MR. NELSON: Yeah. Absolutely.

I would just say I think anytime you start a new process, you work through that process and, inevitably, you see issues that may have not been fully thought through when that process was put together or it may benefit from improvements.

And I think, to the extent we're doing that right now, and the Audit Committee feels that there are improvements that can be made, that's absolutely the type of thing that I would strongly recommend we agendize for a future Audit Committee meeting and make those recommendations to the Board for consideration.

TRUSTEE TULLOCH: Trying to recall, it's been about two years now since (inaudible) this policy because it was left languishing by the previous board.

But I seem to recall it's -- you're free to just reject, you know, what your findings are, they're frivolous, they can just be rejected. They don't require reporting or further elucidation.

CHAIR NOLET: Good question. Good suggestion. I'll check on that.

I guess my -- our, sort of, honeymoon period with this policy is I wanted to show that we had maximum response to the community. I think setting some calling is appropriate, and we'll do that.

But right now, in the community, it wouldn't be surprising if one or two authors might have good concern that we just weren't going to address their comments, so we're going to address them all, and then we'll window that down over time.

That closes out D 5.

E. CONSENT CALENDAR

CHAIR NOLET: We have minutes from the March 30th meeting. If anybody had any comments or questions? Hearing none, can I have a motion to approve the minutes?

MEMBER HOMAN: I put a motion that we approve the minutes.

TRUSTEE TULLOCH: I'll second.

CHAIR NOLET: All in favor?

TRUSTEE SCHMITZ: Aye.

TRUSTEE TULLOCH: Aye.

MEMBER BRANDLE: Aye.

MEMBER HOMAN: Aye.

CHAIR NOLET: Aye.

No opposition, so I think we can consider them approved. I believe that leaves public comment before we adjourn.

F. PUBLIC COMMENTS

MR. DOBLER: Cliff Dobler, 995 Fairway.

What I'd like to ask is -- Chris and Mick worked very diligently with me in March, regarding -- I think we had 26 outstanding memorandums that were probably created over a couple years, and, if I recall, all but nine of them were more or less resolved; either that it was immaterial, it's being corrected, and would think at this time -- and I know it's a lot of work for you guys -- do a closing letter on those 26 minus 9, would be 17, so they're off the books, they're out of the way. And then these last nine that you're still dealing with, we'll just keep them open.

But it's -- I don't want wait until the nine are resolved, and then get a report from you guys about how we resolved them two years from now.

I may be dead. I just turned 75. Okay?

So could you do that? I mean, that would be a fair thing, I think. I did the hard work. It's been over a two-and-a-half year period now, and if they've been resolved, they've been resolved and should be off the books and put to bed.

CHAIR NOLET: Is that it?

MR. DOBLER: No. But, maybe, yeah, I'll do that.

CHAIR NOLET: Yeah. But during this meeting, I'm trying to be a little more responsible on --

MR. DOBLER: And then the last thing, Chris and --

CHAIR NOLET: Just hit pause on that. So there were 28 items, we've closed --

MR. DOBLER: Nineteen of them, yeah.

CHAIR NOLET: Paul was going to write those up, of course he's gone. I probably have the best notes, not very legible, but between the two of us, we will do it. To be honest, we committed to ourselves that we wouldn't do any unnecessary working in August.

MR. DOBLER: All right. Well, the point is --

CHAIR NOLET: You'll have to wait until September for that.

MR. DOBLER: The point is that they're out there, and Jennifer should probably know about them, that you're making headway. And it's the right thing to do, so I'd like to see that done.

The other thing is is on -- Chris, I think you did a real bad thing here, mentioning two names of two trustees that are on a recall witch hunt on two things that, within minutes, that's going to be on Facebook, and it's all going to be twisted about she's been robbing the till for her benefits, and how Dent is grabbing money from a rich guy in Incline Village for a loan.

You need to correct that because this is -- that was bad. That was just adding fuel to the fire that you have those out there, you're not resolving it, so the opposition or whatever you want to call them, they're going to use that as continuing the witch hunt. And it's very bad, and it was a horrible thing to do.

The last thing is, the big one that we have -- I think, Mick, you may have seen it -- about the look-back on a lot of the capital projects.

I think we need to get resolved the idea of componentizing certain assets, otherwise, the writeoffs would be quite substantial. And I'm thinking more about the sewer and water pump stations.

Anyways, maybe the discussion of that should take place before we delve into that $7, $8 million, that may be written off while we're capitalizing components, and then studying the conglomeration of what was thrown into these projects and consider that some pieces are components and should be capitalized and amortized over a useful life.

That's all I have. Thank you.

CHAIR NOLET: So, Josh, you can help with this. I stand fully corrected. It was a horrible thing to do. It was a rookie mistake. I shouldn't do it. I won't do it again.

Josh, can I give some preliminary findings on those two matters to help balance this discussion or no?

MR. NELSON: We already kind of closed the item, so if the Board would like to reopen it, then we can -- if the committee would like to reopen it, we can reopen it, and then we would need to do public comment again.

I do think, though, we didn't provide notice to those folks that it would be provided, so I am concerned about going back to that.

What I think we can say is what I hope anyone who is watching this saw is that, and, Chris, correct me, but your discussion of open items shouldn't be construed as any sort of finding that there's violation by anyone who's mentioned, but simply a report to the community of the complaints that have been received and your diligent review of those.

CHAIR NOLET: Perfectly said. Thank you.

I hope everybody watching just listens to that, because that was my intent. A little over-disclosure. My mistake. Sorry.

Are there any other matters before us before we adjourn?

TRUSTEE TULLOCH: Thank for doing a good job. It's nice to have -- I think this is the first in-person Audit Committee meeting for about years. Very refreshing, and good job, Chris.

TRUSTEE SCHMITZ: My only request is do we have a long-range calendar that we planned out as of yet?

CHAIR NOLET: We don't yet. We have to

develop that. We don't have one yet.

Vito?

MEMBER BRANDLE: No other comments.

G. ADJOURNMENT

CHAIR NOLET: Okay. We're adjourned.

(Meeting adjourned at 4:02 P.M.)

STATE OF NEVADA)
) ss.
COUNTY OF WASHOE)

I, BRANDI ANN VIANNEY SMITH, do hereby certify:

That I was present on July 24, 2023, at the Audit Committee Meeting via Zoom, and took stenotype notes of the proceedings entitled herein, and thereafter transcribed the same into typewriting as herein appears.

That the foregoing transcript is a full, true, and correct transcription of my stenotype notes of said proceedings consisting of 76 pages.

DATED: At Reno, Nevada, this day of 1st August, 2023.

/s/ Brandi Ann Vianney Smith

____
BRANDI ANN VIANNEY SMITH

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WRITTEN STATEMENT TO BE ATTACHED TO AND MADE A PART OF THE WRITTEN MINUTES OF THE IVGID AUDIT COMMITTEE'S REGULAR JULY 24, 2023 MEETING – AGENDA ITEM D(1) – STAFFING UPDATE

Introduction: I understand there's going to be an update of our staffing woes. However in anticipation, I submit this written statement.

Look at how many senior staff we've lost/are in the process of losing within the last several months. And look at how many we've been unable to replace. There's a problem here and it's not me. Nor Trustee Schmitz. It goes far, far deeper. And as Reverend Jeremiah Wright observed after 9/11[1], "the chickens have come home to roost."

What did Rev. Wright mean, and what application does it have to the District? God damn IVGID for what you've done in the past, and what you caused what we're facing today. It has all be building up to today. The chickens have come home to roost!

My E-Mail of July 19, 2023: On July 19, 2023 I sent an e-mail to the committee[2] commenting on the extent of senior personnel we have lost, are in the process of losing, and who can't seem to be replaced. Rather than regurgitate the comments, I refer the reader to the same.

Conclusion: The problems we are facing today go back to the wrongs committed decades ago. And now they're all coming to a head. We see this with the divisiveness in our community, the current recall petition circulating, the disrespect many in our community have for those with differing views, and the incompetent and grossly over compensated and over benefited employees that we have. This is all coming to a head. And as Rev. Wright has observed, "the chickens have come home to roost."

Respectfully, Aaron Katz (Your Community Watchdog Because Nearly No One Else Seems to be Watching).

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[1] Go to https://www.nationalreview.com/the-campaign-spot/obamas-pastor-after-911-americas-chickens-are-coming-home-roost-jim-geraghty/.

[2] That e-mail is attached as Exhibit "A" to this written statement.

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EXHIBIT "A"

July 24, 2023 IVGID Audit Committee Meeting, Agenda Item D(1) - The Key Senior Staff We Have Lost

From: <s4s@ix.netcom.com>
To: "Nolet Chris" <cnolet99@gmail.com>
Subject: July 24, 2023 IVGID Audit Committee Meeting, Agenda Item D(1) - The Key Senior Staff We Have Lost
Date: Jul 19, 2023 12:49 PM

Chairperson Nolet and Other Honorable Members of the IVGID Audit Committee:

I submit public comment with respect to this matter.

Can you please share these comments with other Board members and Mr. Magee prior to the meeting?

At the last IVGID Board meeting, a member of the public gave public comment to the effect that when you have a mass exodus of key employees, like we do, you have a problem. And the simple answer to the reason why is not Trustee Schmitz. We have a problem.

And I presume Mr. Magee is going to speak to this problem as part of this agenda item. And just so we're on the same page, below find a list of the key employees I am aware of that we've lost or never placed. Which now makes me ask the question: why do we have an HR person? I know why. But if she can't placed these key positions for whatever the reasons, then we're no worse off not having an HR person.

So here are our key employee vacancies I am aware of:

1. Our GM of course who according to his own press release, voluntarily separated from the District after twenty (20) years of employment to spend more time with his family (now why would one of our longest lasting employees all of a sudden choose to leave his position and spend more time with his family?);

2. Our under qualified (he didn't even have a C.P.A.) Director of Finance (who viewed his job as protecting his colleagues rather than the public);

3. Our Controller (Marty Williams) who left six or more months ago and still we've been unable to replace him - notwithstanding we're offering a starting salary of $100,204-$120,245/yr (how about hiring local resident Joy Gumz? She is a C.P.A. and wants the job);

4. Our Revenue Manager who left months ago and we've been unable to replace him - notwithstanding we're offering a starting salary of $86,355 – $102,055/yr;

5. "The addition of a new (full time, fully benefited) HR/Recruitment Assistant" (this appeared in the budget the Board approved). Have we found anyone yet?

6. Our Director of Public Works (he was so capable he couldn't take on a project without incurring the added cost of a CMAR);

7. Our Director of Food & Beverage (who used to be nothing more than a chef);

8. Our Sous Chef who apparently left months ago and we've been unable to replace - notwithstanding we're offering a starting salary of $2,500.00 bi-weekly;

9. Our District Clerk who left months ago (after being on the job for only a couple of months) and we've been unable to replace; and,

10. Our attorneys who announced at the Board's July 12, 2023 meeting that they would no longer be representing the District when its current legal services agreement terminates in December of this year.

I'm sure there are more such employees I don't know of. However, I submit that this list is bad enough!

And like I said. We have a problem here.

Respectfully, Aaron Katz