

CHARTER SCHOOL CONFLICT OF INTEREST LAWS AND POLICIES (INCLUDING LAUSD POLICIES)

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Overview

Under California's charter school law, a charter school may operate as or elect to be operated by a nonprofit public benefit corporation. Various external laws and policies govern the conduct of directors, officers and employees of a nonprofit public benefit corporation that operates an LAUSD charter school. These laws and policies may prohibit a director, officer or employee of a charter school from making, participating in, or influencing or attempting to influence a decision of the charter school concerning a transaction in which the director, officer or employee or a member of his or her immediate family has a financial interest.

Corporations Code § 5231

Section 5231 of the California Corporations Code requires a director of a nonprofit public benefit corporation to perform the duties of a director in good faith in a manner that the director believes to be in the best interests of the corporation.

Section 5231 does not prohibit a director of a charter school from making, participating in making, or attempting to influence decisions of the charter school concerning a transaction between the school and a third party of which the director or a member of the director's immediate family is a director, officer or employee, so long as the director believes in good faith that the director is acting in the best interests of the school.

Corporations Code § 5233

Section 5233 of the Corporations Code effectively prohibits a nonprofit public benefit corporation from entering into a "self-dealing transaction," which is one in which one or more of its directors has a material financial interest, unless, among other exceptions, (A) the corporation entered into the transaction for its own benefit; (B) the transaction was fair and reasonable as to the corporation at the time the corporation entered into the transaction; (C) prior to consummating the transaction or any part thereof the board authorized or approved the transaction in good faith by a vote of a majority of the directors then in office without counting the vote of the interested director or directors, and with knowledge of the material facts concerning the transaction and the director's interest in the transaction; and (D) (i) prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances or (ii) the corporation in fact could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.

For purposes of section 5233, a director of a charter school may be deemed to have a material financial interest in a transaction between the school and a third party of which the director or a member of the director's immediate family is a director, officer or employee. Section 5233, however, does not prohibit a director of a charter school from making, participating in making, or attempting to influence

decisions of the charter school concerning a transaction in which the director has a material financial interest, provided that the transaction falls within one of the approved types of self-dealing transactions.

Government Code §1090 et seq.

Section 1090 of the Government Code provides, “Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members.”

Section 35233 of the Education Code provides:

The prohibitions contained in Article 4 (commencing with Section 1090) and Article 4.7 (commencing with Section 1125) of Division 4 of Title 1 of the Government Code are applicable to members of governing boards of school districts and to members of citizens’ oversight committees appointed by those governing boards pursuant to Chapter 1.5 (commencing with Section 15264) of Part 10.

Section 47610 of the Education Code provides:

A charter school shall comply with this part and all of the provisions set forth in its charter, but is otherwise exempt from the laws governing school districts, except all of the following:

(a) As specified in Section 47611 [relating to participation in the State Teachers’ Retirement System or the Public Employees Retirement System].

(b) As specified in Section 41365 [relating to the Charter School Revolving Loan Fund].

(c) All laws establishing minimum age for public school attendance.

(d) The California Building Standards Code (Part 2 (commencing with Section 101) of Title 24 of the California Code of Regulations), as adopted and enforced by the local building enforcement agency with jurisdiction over the area in which the charter school is located.

(e) Charter school facilities shall comply with subdivision (d) by January 1, 2007.

Whether Government Code sections 1090 *et seq.* apply to charter school officials and employees as a matter of law is open to question.

Under section 1091(a) of the Government Code, an officer (which would include a director of a charter school, if the law applies to charter school officials) shall not be deemed to be interested in a contract entered into by a body or board of which the officer is a member if the officer has only a remote interest in the contract and if the fact of that interest is disclosed to the body or board of which the officer is a member and noted in its official records, and thereafter the body or board authorizes, approves, or ratifies the contract in good faith by a vote of its membership sufficient for the purpose without counting the vote or votes of the officer or member with the remote interest.

For purposes of section 1091, a "remote interest" includes that of an officer or employee of a nonprofit entity exempt from taxation pursuant to section 501(c)(3) of the Internal Revenue Code or a nonprofit corporation, except as provided in paragraph (8) of subdivision (a) of section 1091.5 (relating to noncompensated officers of certain nonprofit corporations). Cal. Gov't Code § 1091(b)(1).

Section 1091, however, is not applicable to any officer interested in a contract who influences or attempts to influence another member of the body or board of which he or she is a member to enter into the contract. Cal. Gov't Code § 1091(c).

Under section 1091.5(a)(7) of the Government Code, an officer or employee shall not be deemed to be interested in a contract if his or her interest is that of a nonsalaried member of a nonprofit corporation, provided that this interest is disclosed to the body or board at the time of the first consideration of the contract, and provided further that this interest is noted in its official records.

Under section 1091.5(a)(8) of the Government Code, an officer or employee shall not be deemed to be interested in a contract if his or her interest is that of a noncompensated officer of a nonprofit, tax-exempt corporation, which, as one of its primary purposes, supports the functions of the body or board or to which the body or board has a legal obligation to give particular consideration, and provided further that this interest is noted in its official records.

For purposes of sections 1091.5(a)(7) and 1091.5(a)(8), an officer is "noncompensated" even though he or she receives reimbursement from the nonprofit, tax-exempt corporation for necessary travel and other actual expenses

Under section 1097 of the Government Code, every contract made in violation of any of the provisions of section 1090 may be avoided at the instance of any party except the officer interested therein, and every officer or person prohibited by section 1090 from being interested in contracts, including any member of the governing board of a school district, who willfully violates any of the provisions of such laws, is punishable by a fine of not more than one thousand dollars (\$1,000), or by imprisonment in the state prison, and is forever disqualified from holding any office in California. Cal. Gov't Code §§ 1092(a), 1097.

The willful failure of an officer to disclose the fact of his or her interest in a contract pursuant to section 1091 is punishable as provided in section 1097. Cal. Gov't Code § 1091(d). That violation does not void the contract unless the contracting party had knowledge of the fact of the remote interest of the officer at the time the contract was executed. *Id.*

Section 1099 of the Government Code provides:

(a) A public officer, including, but not limited to, an appointed or elected member of a governmental board, commission, committee, or other body, shall not simultaneously hold two public offices that are incompatible. Offices are incompatible when any of the following circumstances are present, unless simultaneous holding of the particular offices is compelled or expressly authorized by law:

(1) Either of the offices may audit, overrule, remove members of, dismiss employees of, or exercise supervisory powers over the other office or body.

(2) Based on the powers and jurisdiction of the offices, there is a possibility of a significant clash of duties or loyalties between the offices.

(3) Public policy considerations make it improper for one person to hold both offices.

(b) When two public offices are incompatible, a public officer shall be deemed to have forfeited the first office upon acceding to the second. This provision is enforceable pursuant to Section 803 of the Code of Civil Procedure.

(c) This section does not apply to a position of employment, including a civil service position.

(d) This section shall not apply to a governmental body that has only advisory powers.

(e) For purposes of paragraph (1) of subdivision (a), a member of a multimember body holds an office that may audit, overrule, remove members of, dismiss employees of, or exercise supervisory powers over another office when the body has any of these powers over the other office or over a multimember body that includes that other office.

(f) This section codifies the common law rule prohibiting an individual from holding incompatible public offices.

Government Code §87100 et seq. (Political Reform Act)

Section 87100 of the Government Code provides, “No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.” Section 82048 of the Government Code defines a “public official” as “every member, officer, employee or consultant of a state or local government agency”

Whether Government Code sections 81700 *et seq.* apply to charter schools as a matter of law also is open to question. In written advice letters, the California Fair Political Practices Commission has taken the position that all charter schools organized pursuant to Education Code section 47600 *et seq.* are local government agencies for purposes of the Political Reform Act, and therefore the board members of a charter school are public officials subject to the conflict-of-interest provisions and Form 700 filing requirements of the Act. In other contexts, other state agencies and the Internal Revenue Service have taken the position that a nonprofit public benefit corporation is not a government agency simply by reason of its operation of a charter school.

Section 87103 of the Government Code describes when a public official has a financial interest in a decision:

A public official has a financial interest in a decision within the meaning of Section 87100 if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally, on the official, a member of his or her immediate family, or on any of the following:

(a) Any business entity in which the public official has a direct or indirect investment worth two thousand dollars (\$2,000) or more.

(b) Any real property in which the public official has a direct or indirect interest worth two thousand dollars (\$2,000) or more.

(c) Any source of income, except gifts or loans by a commercial lending institution made in the regular course of business on terms available to the public without regard to official status, aggregating five hundred dollars (\$500) or more in value provided or promised to, received by, the public official within 12 months prior to the time when the decision is made.

(d) Any business entity in which the public official is a director, officer, partner, trustee, employee, or holds any position of management.

(e) Any donor of, or any intermediary or agent for a donor of, a gift or gifts aggregating two hundred fifty dollars (\$250) or more in value provided to, received by, or promised to the public official within 12 months prior to the time when the decision is made. The amount of the value of gifts specified by this subdivision shall be adjusted biennially by the commission to equal the same amount determined by the commission pursuant to subdivision (f) of Section 89503.

For purposes of section 87103, a “business entity” excludes a nonprofit corporation. Cal. Gov’t. Code § 82005.

Section 87105 of the Government Code provides:

(a) A public official who holds an office specified in Section 87200 who has a financial interest in a decision within the meaning of Section 87100 shall, upon identifying a conflict of interest or a potential conflict of interest and immediately prior to the consideration of the matter, do all of the following:

(1) Publicly identify the financial interest that gives rise to the conflict of interest or potential conflict of interest in detail sufficient to be understood by the public, except that disclosure of the exact street address of a residence is not required.

(2) Recuse himself or herself from discussing and voting on the matter, or otherwise acting in violation of Section 87100.

(3) Leave the room until after the discussion, vote, and any other disposition of the matter is concluded, unless the matter has been placed on the portion of the agenda reserved for uncontested matters.

(4) Notwithstanding paragraph (3), a public official described in subdivision (a) may speak on the issue during the time that the general public speaks on the issue.

(b) This section does not apply to Members of the Legislature.

Any person who knowingly or willfully violates section 87100 is guilty of a misdemeanor, and if it is ultimately determined that a violation has occurred and that the official action might not otherwise

have been taken or approved, the court may set the official action aside as void. Cal. Gov't. Code §§ 91000(a), 91003(b).

The California Fair Political Practices Commission has adopted regulations interpreting the provisions of sections 87100 *et seq.* of the Government Code. Section 18702.3(a) of title 2 of the California Code of Regulations states:

With regard to a governmental decision which is within or before an official's agency or an agency appointed by or subject to the budgetary control of his or her agency, the official is attempting to use his or her official position to influence the decision if, for the purpose of influencing the decision, the official contacts, or appears before, or otherwise attempts to influence, any member, officer, employee or consultant of the agency. Attempts to influence include, but are not limited to, appearances or contacts by the official on behalf of a business entity, client, or customer.

Section 87407 of the Government Code provides that no public official shall make, participate in making, or use his or her official position to influence, any governmental decision directly relating to any person with whom he or she is negotiating, or has any arrangement concerning, prospective employment.

LAUSD Policy for Charter School Authorizing

LAUSD's *Policy for Charter School Authorizing* revised February 7, 2012, provides, in pertinent part:

C. Conflicts Of Interest

An important responsibility for charter schools is effective and ethical governance. All charter schools authorized by LAUSD commit to the highest level of ethical standards. Charter schools authorized by LAUSD shall comply with all applicable conflict of interests requirements and are subject to, and must comply with, LAUSD's Lobbying Disclosure Code, policies, and procedures in their dealings with LAUSD officials. As a general guide, members of the charter school's executive board; any administrators, managers or employees; and any other committees of the school shall establish and abide by policies and procedures that comply with applicable federal and state laws and regulations, nonprofit integrity standards, and LAUSD Charter School policies and regulations regarding conflicts of interest as part of a reasonably comprehensive description of school governance.

In accordance with the Political Reform Act, as part of compliance with the LAUSD Conflict of Interest Code, every member of a public charter school board of directors and each public charter school officer, employee, or consultant meeting the three-pronged criteria established under state law shall file a state-mandated Form 700 Statement of Economic Interests with the local public school district (1) within 30 days of assuming office, (2) annually thereafter, and (3) within 30 days after leaving office. Each individual's Form 700 Statement of Economic Interest shall remain on file at the charter school's primary administrative office and the LAUSD Ethics Office. Form 700s must be made available, upon request, for inspection by any member of the public. The charter school will ensure that their list of filer positions is current and further ensure that filers understand not only filing requirements but also the requirements regarding conflicts of

interest, self-dealing, and incompatible activities, which should be reasonably set forth in the governance provisions of the charter.

AUTHORITY: California Education Code sections 35160, 47600 et seq. and all sections cited within those provisions;

California Government Code sections 1090, 6250 et seq., 54950 et seq., 81000 et seq.

LAUSD Administrative Procedures for Charter School Authorizing

LAUSD's *Administrative Procedures for Charter School Authorizing* dated August 2010 provides, in pertinent part:

Conflicts of Interest

An important responsibility for charter schools is effective and ethical governance. All charter schools authorized by LAUSD commit to the highest level of ethical standards. Charter schools authorized by LAUSD shall comply with all applicable conflict of interest requirements and are subject to, and must comply with, LAUSD's Lobbying Disclosure Code, policies, and procedures in their dealings with LAUSD officials. As a general guide, members of the charter school's executive board; any administrators, managers or employees; and any other committees of the school shall establish and abide by policies and procedures that comply with applicable federal and state laws and regulations, nonprofit integrity standards, and LAUSD charter school policies and regulations regarding conflicts of interest as part of a reasonable comprehensive description of school governance.

I. Political Reform Act

Enacted in 1974, the Political Reform Act was passed by California voters to promote integrity and transparency in state and local government agencies by helping agency decision makers avoid conflicts between their personal interests and official duties. Under the Act, these individuals are required to disclose certain financial interests on their Form 700 filings.

A. Form 700s

In accordance with the Political Reform Act, as part of compliance with the LAUSD Conflict of Interest Code, every member of a public charter school board of directors and each public charter school officer, employee, or consultant meeting the three-pronged criteria established under state law shall file a state-mandated Form 700 Statement of Economic Interests with the local public school district (1) within 30 days of assuming office, (2) annually thereafter, and (3) within 30 days after leaving office. Each individual's Form 700 Statement of Economic Interest shall remain on file at the charter school's primary administrative office and the original forwarded to ICSD. Form 700s must be made available, upon request, for inspection by any member of the public.

LAUSD Conflict of Interest Code

- “Charter School Providers” have been adopted under the “Non-Employee Filer’s” section of LAUSD’s Conflict of Interest Code. The position was designated “Disclosure Category 8.” For further review and exact language, LAUSD’s Conflict of Interest Code can be found on LAUSD’s Ethics Office website: www.lausd.net/ethics.

Liaison Process & List of Charter School Filers

- April 1 is the statutory deadline for annual filing of the Form 700 SEIs. Prior to April 1 of each year, the Innovation and Charter Schools Division will notify charter school officials of the requirement to file and provide filing instructions. Each charter school or CMO should identify a Form 700 liaison to collect and mail its original SEIs to the Innovation and Charter Schools Division, or submit them in person. Originals must be sent as the state law prohibits e-mails and faxes. Each charter school or CMO should also submit an organizational chart and roster of their designated filers.

Notifications

- Charter school filers that fail to meet the annual April 1 deadline will receive two reminder notices from the Innovation and Charter Schools Division. The Innovation and Charter Schools Division will report to the California Fair Political Practices Commission any filers that remain delinquent thirty (30) days after the date of the second reminder notice.

Late Fines

- The California Fair Political Practices Commission may impose fines on charter school officials that fail to file Form 700 SEIs in the manner described above.

Beyond what is outlined above, it is the responsibility of the charter provider to ensure that charter school employees understand not only filing requirements but also the requirements regarding conflicts of interest, self-dealing, and incompatible activities, which should be reasonably set forth in the governance provisions of the charter.

AUTHORITY: California Education code sections 35160, 47600 et Seq. and all sections cited within those provisions;

California Government Code sections 1090, 6250 et seq., 54950 et seq., 81000 et seq.

ExED's "DO'S" AND "DON'TS" OF CHARTER SCHOOL FISCAL RESPONSIBILITY

DO:

Have a truly independent school Board and adopt a conflict of interest policy

Pay all payroll taxes properly

- Pay taxes to Federal and State Agencies within set deadline
- File quarterly and annual payroll tax filings

Submit timely retirement payments to STRS and PERS

- Talk to County representatives about requirements, proper formats, and timelines
- Maintain \$-for-\$ reserve for all money owed to STRS and PERS

Adopt sound fiscal policies and follow them

Set up proper segregation of duties

Maintain proper supporting documentation for all expenditures.

Have board approved loan documents for all loans made to the school, even if made by the Executive Director or board member.

DON'T:

Do not have employees, relatives of employees, or paid vendors on the school Board

Do not pay Executive Directors way above industry standards or give excessive benefits

Do not make personal loans to school employees

Do not have weak internal controls, with the same person responsible for purchasing, deposits, and check writing.

Do not use school credit card for personal expenditures.

Do not write checks out to "Cash".

Do not write checks to the same person who then signs the checks.

Do not reimburse employees for purchases without receipts.

Tips for Proper Segregation of Duties



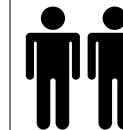
The person that cuts the checks does not reconcile the bank accounts. *If this is not possible, management needs to formally approve and review reconciliation on a monthly basis.*



The person that processes payroll does not receive payroll if outsourced or distribute checks.



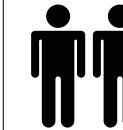
The person that cuts the checks does not sign the checks.



Ensure that all cash is counted by two people. *We recommend a two-key lockbox, available at any office supply store.*



The person that reconciles the bank account(s) does not open the bank statements.



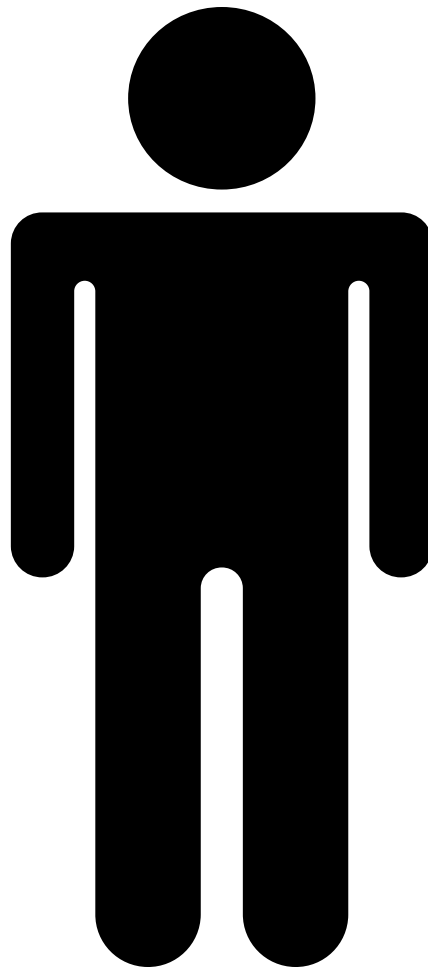
The person that opens the mail does not make bank deposits.



The person that receives goods does not purchase them or process payments for goods.



The person that makes the bank deposits does not reconcile the bank account(s).



WHERE DOES FINANCIAL MISCONDUCT MOST OFTEN OCCUR?

✓ CONFLICT OF INTEREST

- BOARD AND/OR ADMINISTRATION

✓ COLLECTION / DEPOSITING OF CASH

- INADEQUATE RECEIPTING
- NO SEPARATION OF DUTIES

✓ BANK ACCOUNTS

- UNTIMELY RECONCILIATIONS
- UNKNOWN ACCOUNTS
- WEAK CONTROLS OVER DEBIT AND CREDIT CARDS

✓ PAYROLL

- FAKE EMPLOYEES
- OVER-REPORTING HOURS

✓ PURCHASING

- FALSE VENDORS
- KICKBACKS
- PURCHASE IRREGULARITIES

✓ WEAK SUPERVISION

- SMALL ORGANIZATIONS
- SUPERVISOR WORK OVERLOAD
- UNWARRANTED TRUST
- CLOSE FRIENDSHIPS
- COLLUSION

(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.

Fraudulent financial reporting may be accomplished by the following:

- A. Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- B. Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information
- C. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

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):
 - a. High degree of competition or market saturation, accompanied by declining margins
 - b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
 - c. Significant declines in enrollment and increasing failures in either the Charter environment or overall economy
 - d. Operating losses making the threat of closure
 - e. Recurring negative cash flows from operations and an inability to generate cash flows from operations while reporting earnings and earnings growth
 - f. Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
 - g. 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:
 - a. 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
 - b. Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
 - c. Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
 - d. 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:
 - a. Significant financial interests in the entity

- b. 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 flow¹
 - c. 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:
 - a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
 - b. 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 nonarm's-length transactions
 - c. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
 - d. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
 - e. Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
 - f. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
- B. There is ineffective monitoring of management as a result of the following:
 - a. Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
 - b. 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:
 - a. Difficulty in determining the organization or individuals that have controlling interest in the entity
 - b. Overly complex organizational structure involving unusual legal entities or managerial lines of authority
 - c. High turnover of senior management, counsel, or board members
- D. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
 - b. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
 - c. 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, which 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

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.

fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- A. 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
- B. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- C. 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
- D. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- E. A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- F. Management failing to correct known significant deficiencies or material weaknesses in internal control on a timely basis
- G. An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- H. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- I. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
- J. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
- K. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
- L. 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
- M. 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

(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.

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.

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

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:
 - a. Known or anticipated future employee layoffs
 - b. Recent or anticipated changes to employee compensation or benefit plans
 - c. 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:
 - a. Large amounts of cash on hand or processed
 - b. Inventory items that are small in size, of high value, or in high demand
 - c. Easily convertible assets, such as bearer bonds, diamonds, or computer chips
 - d. 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:
 - a. Inadequate segregation of duties or independent checks
 - b. Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations
 - c. Inadequate job applicant screening of employees with access to assets
 - d. Inadequate recordkeeping with respect to assets
 - e. Inadequate system of authorization and approval of transactions (for example, in purchasing)
 - f. Inadequate physical safeguards over cash, investments, inventory, or fixed assets
 - g. Lack of complete and timely reconciliations of assets
 - h. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns

- i. Lack of mandatory vacations for employees performing key control functions
- j. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- k. 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:

- A. Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- B. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- C. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- D. 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.]

Fraud Prevention Checklist

The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist is designed to help organizations test the effectiveness of their fraud prevention measures.

1. Is ongoing anti-fraud training provided to all employees of the organization?

- Do employees understand what constitutes fraud?
- Have the costs of fraud to the company and everyone in it including lost profits, adverse publicity, job loss and decreased morale and productivity been made clear to employees?
- Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe that they can speak freely?
- Has a policy of zero-tolerance for fraud been communicated to employees through words and actions?

2. Is an effective fraud reporting mechanism in place?

- Have employees been taught how to communicate concerns about known or potential wrongdoing?
- Is there an anonymous reporting channel available to employees, such as a third-party hotline?
- Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?
- Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?
- Do reporting policies and mechanisms extend to vendors, customers and other outside parties?

3. To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?

- Is possible fraudulent conduct aggressively sought out, rather than dealt with

passively?

- Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?
- Are surprise fraud audits performed in addition to regularly scheduled audits?
- Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

4. Is the management climate/tone at the top one of honesty and integrity?

- Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?
- Are performance goals realistic?
- Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and which are used to determine performance-related compensation?
- Has the organization established, implemented and tested a process for oversight of fraud risks by the board of directors or others charged with governance (e.g., the audit committee)?

5. Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?

6. Are strong anti-fraud controls in place and operating effectively, including the following?

- Proper separation of
duties
- Use of
authorizations

- Physical safeguards
 - Job rotations
 - Mandatory vacations
7. **Does the internal audit department, if one exists, have adequate resources and authority to operate effectively and without undue influence from senior management?**
8. **Does the hiring policy include the following (where permitted by law)?**
- Past employment verification
 - Criminal and civil background checks
 - Credit checks
 - Drug screening
 - Education verification
 - References check
9. **Are employee support programs in place to assist employees struggling with addictions, mental/ emotional health, family or financial problems?**
10. **Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?**
11. **Are anonymous surveys conducted to assess employee morale?**