



OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

12-17
City of Colorado Springs and
Colorado Springs Utilities
Claims Reserve and
Workers' Compensation Fund
Audit

September 2012



OFFICE OF THE CITY AUDITOR

COLORADO SPRINGS, COLORADO

12-17 City of Colorado Springs and Colorado Springs Utilities Claims Reserve Fund and Workers' Compensation Audit Report

September 2012

Purpose

The purpose of this audit was to comply with Section 1.5.602 (I) of the City Code which requires the City Auditor to conduct an examination at least once every two years to determine that the Claims Reserve and Workers' Compensation Fund was utilizing proper underwriting techniques, utilizing sound funding procedures, maintaining adequate reserves, following claims procedures, and following appropriate accounting practices.

Highlights

We concluded that the proper underwriting techniques, claims procedures, and accounting practices were followed in the management and operation of the Claims Liability Reserve and Workers' Compensation Funds. General Liability Claims funding procedures and liabilities accrued were considered adequate for both the City and Colorado Springs Utilities.

Although City Code required funding of the Workers' Compensation Fund, required funding levels were not clear. The City and Colorado Springs Utilities administered the requirement in a way that funding was available when claims were due. However, contributions were not made in an amount to fund the full amount of claim liabilities recorded, so an unfunded liability existed. If contributions could not be made in a given year, the general fund would have to cover the difference.

At the end of 2010, the City Workers' Compensation Net Asset balance would cover 26% of all outstanding claims. Colorado Springs Utilities Net Asset balance would cover 52% of outstanding claims as of December 31, 2010.

(Continued on page 2)

Management Response

Responses were only requested from the City, which administers the Workers' Compensation program. Management was in general agreement with the observations. See detailed responses in the report.

(Continued on page 2)

Recommendations

- 1) System administration functions should not be performed by the Acting Risk Manager, or log reports should be reviewed by the Risk Manager's Supervisor.
- 2) Risk Management should obtain a third party Service Organization Control Report from the software vendor assuring information technology controls are adequate to secure and protect data. The contract with the software vendor should be updated and extended.
- 3) The Acting Risk Manager should review general liability claims before checks are processed, review checks returned to adjusters, and assign claims to adjusters, to ensure all claims are valid.

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(Highlights continued from page 1)

During the course of our audit, we identified areas where we believe internal control can be strengthened or other opportunities for improvement exist.

(Recommendations continued from page 1)

Opportunity for Improvement

1. City Council may wish to consider revising the code to better define whether adequate funding for Workers' Compensation included funding for claims incurred but not yet payable.
2. City Code required the City Auditor to examine the Workers' Compensation and Claims Liability fund at least once every two years. Consideration could be given to revising this code requirement to limit the scope of the review to funding adequacy or to conduct an examination based on a risk assessment.

The audit was conducted in a manner that meets or exceeds the International Standards for the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors, with the exception of the requirements under standards 1312 and 1321 to obtain an external quality assurance review once every five years. We do not believe this non-compliance impacted the quality of our audit.

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Office Of The City Auditor Public Report

Date: September 5, 2012

To: President Hente, President Pro Tem Martin, and Members of City Council

Re: 12-17 City of Colorado Springs & Colorado Springs Utilities Claims Reserve and Workers' Compensation Funds Audit

We conducted an audit of the City of Colorado Springs (City) and Colorado Springs Utilities Liability Claims Reserve and Workers' Compensation Self-Insurance Funds. Our audit focused on the period from January 1, 2009, through December 31, 2010.

The purpose of this audit was to review the Claims Reserve and Workers' Compensation Self-Insurance Funds to determine whether proper underwriting techniques, sound funding procedures, loss reserves, claims procedures, and accounting practices were being followed in the management and operations of these funds.

We concluded that the proper underwriting techniques, claims procedures, and accounting practices were followed in the management and operation of the General Liability Reserve and Workers' Compensation Funds. General Liability Claims funding procedures and loss reserves were considered adequate for both the City and Colorado Springs Utilities.

The Total Net Assets of the Workers' Compensation Fund combined was (\$4.4 million) as of December 31, 2010. While the City's portion of the Net Assets excluding Outstanding Claims has improved, Outstanding Claims have steadily increased. This leaves the City's portion of the deficit Net Assets at (\$3.5 million).

Colorado Springs Utilities portion of the Net Assets, (\$.9 million), has decreased since 2005.

During the course of our audit, we identified three areas where we believe internal control could be strengthened.

As always, feel free to contact me if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Denny Nester".

Denny Nester, MBA, CPA, CIA, CGFM, CFE, CGAP
City Auditor

cc: Steve Bach, Mayor
Laura Neumann, Chief of Staff, City of Colorado Springs



Office of the City Auditor
**City and Colorado Springs Utilities
Claims Reserve and Workers' Compensation Fund**

cc: (continued)

Kara Skinner, Chief Financial Officer, City of Colorado Springs
Mike Sullivan, Director, Human Resources, City of Colorado Springs
Victoria McColm, Acting Risk Manager, City of Colorado Springs
Jerry Forte, Chief Executive Officer, Colorado Springs Utilities
Bill Cherrier, Chief Planning & Financial Officer, Colorado Springs Utilities
Carl Cruz, Chief Customer & Corporate Services Officer, Colorado Springs Utilities
David Padgett, Chief Environment, Health & Safety Officer, Colorado Springs Utilities
Dede Jones, Financial Services General Manager, Colorado Springs Utilities
Sandi Yukman, Human Resources General Manager, Colorado Springs Utilities
Sonya Thieme, Accounting Manager, Colorado Springs Utilities
Dave Maier, Enterprise Risk Management Manager, Colorado Springs Utilities
Dominic Romano, Safety & Health Manager, Colorado Springs Utilities



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Office of the City Auditor City and Colorado Springs Utilities Claims Reserve and Workers' Compensation Fund

REPORT DETAILS

PURPOSE AND SCOPE

We performed an audit of the City of Colorado Springs and Colorado Springs Utilities Claims Liability Reserve and Workers' Compensation Funds. The purpose of the audit was to evaluate the adequacy of existing underwriting techniques, funding procedures, loss reserves, claims procedures and accounting practices in place in the management and operations of the Claims Reserve and Workers' Compensation Funds. We evaluated whether these processes were functioning as intended and enabled the organizations objectives and goals to be met.

The scope of the audit included review of the processes used in claims handling procedures, evaluation of the control environment and internal controls in place, and verification that adequate loss reserves and funding existed. Our audit covered the period from January 1, 2009 through December 31, 2010.

To accomplish our audit objectives, we reviewed departmental policies and procedures and obtained an understanding of the internal control structure for claims management. We reviewed City and Colorado Springs Utilities' Claims Reserve Fund Committee reports to analyze the adequacy of funding for the Liability and Workers' Compensation claims, and interviewed management and staff.

BACKGROUND

The City and Colorado Springs Utilities were self-insured for both Workers' Compensation and General Liability Claims. General Liability would include property claims such as damage to personal property claimed by the public. The City administered the Workers' Compensation and General Liability Claims processes on behalf of Colorado Springs Utilities.

The City Code required that the City Auditor perform a review of the General Liability Claims and Workers' Compensation Funds at least once every two years. Our prior audit periods for the Claims Reserve Fund and Workers' Compensation Fund audit were January 1, 2007, to December 31, 2008, and January 1, 2008, to December 31, 2008, respectively.

The City Risk Management Department employees administered all aspects of the claims process, to include initiating loss or injury reports, investigating claims, updating vendors, and authorizing and initiating payments to be made by the Accounts Payable function.

The City Risk Management Department was organized into two sections—General Liability Claims and Workers' Compensation. In the prior audit period, each had two adjusters reporting to a Supervisor, who in turn reported to the Risk Manager. Since September 2010, the City Risk Manager and General Liability Claims Supervisor positions have been vacant. These responsibilities have been performed by the Acting Risk Manager, formerly the Risk Supervisor. An administrative employee performed much



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of the data input related to setup and payment processing. Claims were processed utilizing a vendor-hosted and supported software system.

For 2009, 846 General Liability claims and 466 Workers' Compensation claims were filed against the City and Colorado Springs Utilities. In 2010, 961 liability claims and 417 Workers' Compensation claims were filed against the City and Colorado Springs Utilities.

Organizations that administered their own Workers' Compensation programs were required to have excess insurance policies for large claims. For 2010, this excess insurance policy covered Workers' Compensation claims over a \$750,000 self insured retention per claim.

General Liability claims against the City were paid from the Claims Reserve Self-Insurance Fund. Although City Risk Management administered claims on behalf of Colorado Springs Utilities, these payments were not made from a common fund. Instead, Colorado Springs Utilities maintained a separate reserve account and paid claims directly as recommended by City Risk Management.

Under City Code section 1.5.503, the City Risk Manager or Acting Risk Manager was authorized to settle liability claims under \$50,000. Settlements between \$50,000 and \$100,000 were approved by a Claims Review Board. The Board consisted of the Mayor, for claims against the City, Colorado Springs Utilities Executive Director for claims against Colorado Springs Utilities, the City Attorney, Chief Financial Officer, and the affected department, division, office or agency directors or managers. Claims with proposed settlement amounts that exceeded \$100,000 required City Council approval.

City of Colorado Springs Workers' Compensation Funding

The City Claims Reserve Fund Committee recommended additional contributions to the fund both in 2009 (\$3.8 million) and 2010 (\$4.0 million). The City exceeded the Committee contribution recommendations both in 2009 (\$4.25 million) and 2010 (\$4.38 million). However, outstanding claims have continued to increase from \$3.76 million in 2008 to \$4.72 million in 2010.

City of Colorado Springs	2008	2009	2010
Revenue	\$4,262,034	\$4,277,113	\$4,399,436
Claims and expenses	(\$3,791,402)	(\$4,266,487)	(\$3,702,349)
Annual Gain or Loss	\$470,632	\$10,626	\$697,088
Net Assets excluding Outstanding Claims	\$530,416	\$541,043	\$1,238,130
Outstanding Claims	(\$3,759,028)	(\$3,957,572)	(\$4,723,490)
Total Net Assets	(\$3,228,612)	(\$3,416,529)	(\$3,485,360)



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The Net Assets excluding Outstanding Claims as of December 31, 2010, was \$1,238,130 and would have covered 26% of the outstanding claims of \$4.7 million. The Net Assets excluding Outstanding Claims in 2009 of \$541,043 would have covered 13.7% of outstanding claims of approximately \$4 million. If the current year contribution in addition to the Workers' Compensation Fund were not sufficient to cover current year claims and prior year claims approved for payment, the City General Fund would have to cover the difference.

Colorado Springs Utilities Workers' Compensation Funding

For the calendar years 2009 and 2010, expenses and claim payments exceeded contributions and revenues by approximately \$.47 million. This fund has experienced a net loss for the past six years, reducing the Fund Balance by an average \$.54 million per year. The 2010 year-end Fund Balance was \$.97 million with claims outstanding of \$1.87 million, resulting in a net deficit of \$.91 million.

Colorado Springs Utilities	2008	2009	2010
Revenue	\$1,582,052	\$1,582,946	\$1,835,613
Claims and Expenses	(\$2,343,128)	(\$1,961,934)	(\$1,928,108)
Annual Gain or Loss	(\$761,076)	(\$378,987)	(\$92,495)
Net Assets excluding Outstanding Claims	\$1,438,333	\$1,059,346	\$966,851
Outstanding Claims	(\$1,873,916)	(\$2,131,708)	(\$1,874,245)
Total Net Assets	(\$435,583)	(\$1,072,362)	(\$907,394)

Colorado Springs Utilities established a Claims Reserve Fund Committee in 2009 which was responsible for reviewing funding levels and recommending contributions to the Workers' Compensation Fund. This Committee included Colorado Springs Utilities managers as well as the City Acting Risk Manager. In both 2009 and 2010, the Colorado Springs Utilities Funding Committee recommended increases in funding contributions (\$1.84 million in 2009 and \$2.13 million in 2010). The Committee also believed, however, claims were decreasing due to better risk management. The actual contributions made by Colorado Springs Utilities to the fund were \$1.56 million in 2009 and \$1.82 million in 2010.

The Net Assets excluding Outstanding Claims as of December 31, 2010, was approximately \$.97 million and would have covered 52% of the outstanding claims of \$1.9 million. The Net Assets excluding Outstanding Claims on December 31, 2009, of approximately \$1.1 million would have covered 50% of \$2.1 million in outstanding claims. If annual contributions were not sufficient to pay current year claims and expenses, the fund would be unable to pay all outstanding claims and Colorado Springs Utilities would have to pay the difference.



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City Code includes the following related to adequate funding: "maintain reserves to provide for contingency so that in any year the contribution of the Workers' Compensation claim reserve funds from other funds is adequate to cover the actual expenses realized in that year." We noted the City and Colorado Springs Utilities have made adequate contributions to cover payments on the current year and outstanding claims on a "pay as you go basis." Please see more details in the Opportunity for Improvement section in this report which relates to defining adequate reserve levels.

COMMENDABLE PRACTICES

The City of Colorado Springs engaged Summit Point Consulting to conduct an analysis of the City's current Workers' Compensation management program in May of 2011. Summit Consulting concluded that the City's self-insured program was a reasonable alternative for the City. The Analysis noted the City's claims handling performance was excellent and exceeded many of the standards in the insurance industry.

The Claim's Reserve and Workers' Compensation staff were cooperative and responsive to our audit and recommendations as evidenced by the work they completed prior to the issuance of our report to correct issues brought to their attention.

CONCLUSION

Based on the audit procedures performed, we conclude proper underwriting techniques, claims procedures, and accounting practices were followed in the management and operation of the General Liability Claims Reserve and Workers' Compensation Funds. General Liability Claims funding procedures and liabilities accrued were considered adequate for both the City and Colorado Springs Utilities.

City funding procedures and Net Asset balances for Workers' Compensation were questioned in the prior audit report dated April 28, 2010. In this audit, we have noted that there are opportunities for improvement related to clearly defining adequate funding requirement. While the City has improved the condition of the loss reserve balance, we believe continued improvement may be merited. Colorado Springs Utilities Workers' Compensation Net Asset balances have declined since 2008 due to net losses for the past six years. We believe the Net Asset balances for both entities should be monitored closely and City Council may want to give guidance on what is meant by adequate funding.

During the course of our audit, we identified areas where we believe internal control could be strengthened along with two opportunities for improvement. These areas are detailed in the following pages.



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OBSERVATIONS, RECOMMENDATIONS AND RESPONSES

OBSERVATION 1 – THE ACTING CITY RISK MANAGER SHOULD NOT BE THE SYSTEM ADMINISTRATOR

The City Acting Risk Manager performed system administration duties for claims processing system. The System Administrator duties included adding and deleting users, creating user profiles, and updating passwords for system users. The claims system did not allow users to enter and change their own password. These abilities created the opportunity to process transactions under another employee's user ID. Since the Acting Risk Manager performed claim reviews, an improper payment might not be detected.

City Risk Management has taken steps to mitigate some risk related to the Acting Risk Manager's role as system administrator since our prior audit. These mitigating controls included separate user profiles to perform administrative activities and supervisor functions, and disabling the ability to turn off transaction logging. Additionally, a transaction log was put in place. However, the log report was not reviewed by anyone such as the Acting Risk Manager's Supervisor, so this reduced the effectiveness of the control.

Some risk still exists that the Acting City Risk Manager could change permissions, then enter, process, and pay fictitious claims such as general liability claims.

AUDITOR'S RECOMMENDATION

The City Acting Risk Manager's Supervisor should review log reports, or system administration duties should be transferred to someone independent of transaction processing.

CITY'S RESPONSE

While no improper transactions have taken place since the inception of the program, the system administration duties have been removed from the Acting Risk Manager role and assigned to another user who does not perform transaction processing.



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OBSERVATION 2 – CITY RISK MANAGEMENT DID NOT OBTAIN A THIRD PARTY REPORT ON INFORMATION SECURITY CONTROLS FROM THE SOFTWARE VENDOR

Claims were processed using a web-based system hosted by a software vendor. Vendors processing data via the web should provide their customers with a report from a third party on information security and data processing controls, known as Service Organization Control (SOC) reports. These reports provide assurance that the web hosting vendor has adequate information technology controls to ensure the integrity of processed data and to protect data from disclosure.

We noted that the applicable SOC report on the effectiveness of the security, availability, processing integrity, confidentiality, or privacy of information processed, had not been obtained from the vendor by City Risk Management.

Additionally, we noted the contract was effective in 2005 for a five-year term. This five-year term could be renewed for an additional five years, but had not been extended at the time of our review.

AUDITOR'S RECOMMENDATION

City Risk Management should obtain the Service Organization Control (SOC) report from the software vendor that hosts the application used to process Workers' Compensation and General Liability claims.

In addition, City Risk Management should update the system support contract with the vendor. The contract should be updated to ensure pricing, terms and conditions are documented.

CITY'S RESPONSE

We have communicated with our database vendor, Mountain View Software Company. Mountain View is in transition, moving the data to a separate facility. This should be completed within the next three months. At that time an SOC will be available and provided.



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OBSERVATION 3 – SEGREGATION OF DUTIES OVER PROCESSING AND PAYMENT OF GENERAL LIABILITY CLAIMS WAS NOT ADEQUATE

In our prior audit, the General Liability Claims Supervisor obtained all the messages from potential claimants received by the department, then assigned claims to adjusters. This process provided some assurance that the claim was valid because the adjuster would not know who would be assigned the claim, and the Supervisor had first-hand knowledge that a claim report was received from the public. This process strengthened the internal control environment.

However, the General Liability Claims Supervisor position was eliminated. The current practice is for adjusters to take claim reports from voice mail without involvement from Supervision, which weakened the control environment discussed in the prior paragraph. Some compensating controls were in place to mitigate this risk. The City Acting Risk Manager performed claims file reviews on a sample of claim files throughout the year as part of performance management, but not all payments were verified to supporting documentation prior to processing. Additionally, checks were returned to General Liability Claims Adjusters in some cases, such as when the claimant would not sign the release without receiving the check.

During our review, this control weakness was communicated to the City Acting Risk Manager and control procedures were put in place. The Acting Risk Manager began reviewing all Liability claim files before the payment request was processed. Additionally, a process change was made to route checks not mailed directly to claimants. These payments were routed first to the Administrative Technician, then to the Acting Risk Manager for review prior to distribution to the adjuster for settlement.

AUDITOR'S RECOMMENDATION

1. The City Acting Risk Manager should review all General Liability claims before checks are processed.
2. If checks are not mailed to the claimant, they should be reviewed by the City Acting Risk Manager before returning to adjusters.
3. The City Acting Risk Manager should assign the claims to the adjusters rather than having the claims self-assigned or the City Risk Manager should contact a sample of claimants to verify the claim.

CITY'S RESPONSE

Subsequent the 2011 audit, recommendations #1 and 2 have been implemented. Recommendation #3 has not been implemented due to limitations in resources. Additional claim files are reviewed monthly to ensure the quality and integrity of the liability claim handling program.



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OPPORTUNITIES FOR IMPROVEMENT

OPPORTUNITY 1 – THE REQUIRED FUNDING LEVEL COULD BE DEFINED MORE CLEARLY

City Code required funding of the Workers' Compensation Fund. However, the required funding levels were not clear. The City and Colorado Springs Utilities administered the requirement in a way that funding was available for claims in the year they were paid. However, contributions were not made in an amount to fund all claim liabilities recorded. Therefore, an unfunded liability existed. If contributions were not adequate in any given year, the General Fund of the City or Colorado Springs Utilities would be required to cover the difference.

City Code 1.5.602: Workers' Compensation Claim Reserve Fund: Section B states, "The workers' compensation claim reserve funds shall maintain reserves to provide for contingency so that in any year the contribution of the workers' compensation claim reserve funds from other funds is adequate to cover the actual expenses realized in that year." Later in the same paragraph, City Code states, "Each fund balance shall include sufficient funds to cover and discharge all known and potential workers' compensation liability and allow for administrative costs in discharging the liability." These two statements appear to conflict with each other. The first statement limits funding to actual expenses realized in a year, while the second calls for funding of all known and potential liability.

AUDITOR'S RECOMMENDATION

City Council could consider revising City Code to better define whether adequate funding for Workers' Compensation included funding for all claims or only for the current years actual expenses.



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OPPORTUNITY 2 – THE CODE REQUIREMENT FOR THIS AUDIT COULD BE RE-EVALUATED

City Code requires the City Auditor to examine the Workers' Compensation and Claims Liability Fund at least once every two years to determine that proper underwriting techniques, sound funding procedures, loss reserves, claims procedures, and accounting practices are being followed. The City Auditor's Office has been performing audits every two years in compliance with these Code requirements.

While this audit has been performed as specified, we noted that the Colorado Department of Workers' Compensation performed compliance based audits on the areas of proper underwriting techniques, loss reserves, and claims procedures. Additionally, Claims Funding Committees were in place to monitor claims and funding. The external audit of the City's financial statements included a review of accounting practices in the City Risk Management areas. These internal and external oversight activities limited the risk associated with Workers' Compensation and General Liability Claims activities.

AUDITOR'S RECOMMENDATION

City Council may want to consider revising the City Code provision that requires the City Auditor to examine the Workers' Compensation and Claims Liability Fund at least once every two years. The scope of the City Auditor's review could be limited to review of the adequacy of funding procedures or the City Auditor could be instructed to conduct a risk assessment and perform audit procedures as warranted.

CITY COUNCIL'S OFFICE OF THE CITY AUDITOR

COLORADO SPRINGS, COLORADO

About our Office

The mission of the Office of the City Auditor is to provide City Council with an independent, objective and comprehensive auditing program for operations of the City. Our auditing program includes:

- Evaluating the adequacy of financial controls, records and operations
- Evaluating the effectiveness and efficiency of organizational operations
- Providing Council, management and employees objective analysis, appraisals, and recommendations for improving systems and activities

The Office of the City Auditor is responsible for auditing the systems used by the City of Colorado Springs and its enterprises, including Colorado Springs Utilities and Memorial Health System. We perform a variety of audits for these entities, including financial audits, performance audits, contract audits, construction audits, and information system audits. We also perform follow-up on a periodic basis to monitor and ensure management actions have been effectively implemented.

Authorization and Organizational Placement

Our audits are conducted under the authority of Chapter 1, Article 2, Part 7 of the Colorado Springs City Code, and more specifically parts 703, 705 and 706 of the Code. The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council.

Audit Standards

The audit was conducted in a manner that meets or exceeds the International Standards for the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors, with the exception of the requirements under standards 1312 and 1321 to obtain an external quality assurance review once every five years. We do not believe this non-compliance impacted the quality of our audit.

The audit will include interviews with appropriate personnel and such tests of records and other supporting documentation as deemed necessary in the circumstances. We will review the internal control structure and compliance tests. Sufficient competent evidential matter was gathered to support our conclusions.