

Audit Federal Financial Controls: *Sooner Rather than Later?*

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The contents of this study have been developed from original material developed by Kearney & Company and excerpts from documents available in the public domain. The writers met with selected Federal officials to discuss this research project, and their comments and suggestions have been incorporated as appropriate.

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TABLE OF CONTENTS

Part I:	
An Earlier AGA Research Study	4
Part II:	
The Case for Auditing Controls over Financial Reporting	5
Section A	
Federal Financial Controls: A Concern of Two Centuries	5
The 1800s and 1900s—Concerns over Controls	
1990s—A Decade of Laws	
Chief Financial Officers Act—1990	
Federal Financial Management Improvement Act—1996	
Section B	
Unfulfilled Expectations: State of Federal Agency Controls	7
Federal Controls in 2000: A Dismal State	
Ineffective Controls, But “Clean” Audit Opinions	
Section C	
Agency Financial Statements: Not the By-products of Systems	8
Financial Statements: Compiled vs. Routine	
Until Sarbanes-Oxley, No Policy to Audit Controls By Congress	
By Government Accountability Office	
By Office of Management and Budget	
By Federal Accounting Standards Advisory Board	
Controls: Concerns, But...	
Section D	
Controls Important, But Not Many Audited	9
Controls: Most Agencies Do Not Audit	
Controls: If Audited, Criteria Not Uniform	
Controls: Most Agencies Do Not Audit Controls	
Section E	
Computers, Systems Complexities Complexity: Controls Don’t Get Easier	10
Modernization and Integration: An Increased Need to Audit Controls	
Effective Controls: New or Simply Revamped?	
Section F	
Sarbanes-Oxley: Assess Controls, Audit Controls	12
Sarbanes-Oxley—Goals of Financial Internal Controls	
Management—Assess Internal Controls	
Auditor—Audit Internal Controls	
One Integrated Audit, but Two Audit Opinions	
Material Weakness—Qualified Opinion	
Attest vs. Audit: Distinction Without Difference	
Section G	
Integrated Controls Framework— Already Federal Policy	14
COSO Integrated Framework: It Works, It’s Accepted	
COSO: Control Definition and Components	
COSO: Technology-Related Controls	
COSO: Acceptance by Federal Agencies	
Section H	
Audit Federal Financial Controls: Sooner Rather than Later	16
Audit Controls, Send a Message	
Audit of Controls: Inevitable	
Section I	
Issues, Next Steps... Who Leads, Who Follows	17
Who Takes Initiative?	
Things to Ponder Sooner or Later	
Cost—May Not be an Issue	
Controls Benchmark: COSO the Federal Standard	
Audit Reports—Remove the “Fog”	
Timing of Audits: More Than “As Of” Year End	
Who Participates, and to Do What?	
Changing the Process: How? How Fast?	

AUDIT FEDERAL FINANCIAL CONTROLS:

Part I

An Earlier AGA Research Study

In 1985, AGA completed a study report titled “Strengthening Controllershship in the Federal Government,” which captured the attention of the National Association of State Auditors, Comptrollers and Treasurers (NASACT), the American Institute of Certified Public Accountants (AICPA), the Government Finance Officers Association (GFOA) and members of Congress.¹ That 1985 report documented a history of events, some evolutionary and others more immediate, that created a need for legislation to ensure that federal financial management processes—its systems, controls, policies, procedures and practices—would meet the government’s future needs. In the report, AGA recommended changes, restructuring and other related initiatives that would improve federal agency financial management. In addition, the report contained a draft of proposed legislation, the Federal Controllershship Act, provisions of which were later codified in the Chief Financial Officers (CFO) Act of 1990.

This AGA Research Study

This study, “Audit Federal Financial Controls: Sooner Rather than Later?” documents the efforts of Congress, federal financial managers, the U.S. General Accounting Office (GAO),² and the U.S. Office of Management and Budget (OMB) to improve the federal government’s internal controls over accounting and financial reporting. This study also explores whether the essence of the Sarbanes-Oxley law might well be applied, with similar benefits, to the the federal government’s financial management practices and be a valuable complement to earlier improvements brought about by the Chief Financial Officers Act of 1990 and the Federal Financial Management Improvement Act (FFMIA) of 1996.

Originally, this study was to span some 15 months over two fiscal years, concluding in June 2005. However, Sarbanes-Oxley changed the environment in 2002 by mandating that an audit of controls of public companies be integrated with the annual audit of an entity’s financial statements. A decision was made by AGA to report on an initial assessment, in three months, at the 2004 AGA Professional Development Conference (PDC).³ The study schedule, considerably abbreviated from the original, had several phases:

Phases	Schedule
Acquire an overview of the history of internal controls	April 2004
Document current practices relating to annual audits	April 2004
Inventory current federal criteria relative to audits of controls	May 2004
Confer with federal stakeholders and share study efforts	June 2004
Provide draft findings to AGA Executive Board and Membership	June 2004
Presentation: AGA’s Professional Development Conference	June 2004
Deliver draft of article to AGA titled, “Audit Federal Financial Controls: Sooner Rather Than Later?”	August 2004
Deliver draft of study report to AGA titled, “Audit Federal Financial Controls: Sooner Rather Than Later?”	August 2004

The study observations are reported in Part II.

Part II

The Case for Auditing Controls Over Financial Reporting

“...No money shall be drawn but in consequence of appropriations made by law, with a regular statement of account of receipts and expenditures of all public money.”

Article 9, Clause 7, The Constitution

“...The federal government is in great need of fundamental reform in financial management requirements and practices,... for improvement in each agency of the federal government, of systems of... internal controls to assure the issuance of reliable financial information and to deter fraud, waste and abuse of federal resources.”

Congress of the United States,

Chief Financial Officers Act, 1990

“Although much effort has been devoted to strengthening federal internal accounting controls in the past,... federal accounting standards have not been uniformly implemented. Federal financial management continues to be seriously deficient,... Federal financial management and fiscal practices have failed to identify costs fully, reflect total liabilities of Congressional actions,... and accurately report the financial condition of the federal government. Continued use of these practices undermines the government’s ability to provide credible and reliable financial data.”

Congress of the United States,

Federal Financial Management Improvement Act, 1996

Since the time of the Constitution, Congress has desired that sounder, more effective internal controls be designed, implemented and used by federal agencies. Throughout the 1800s and 1900s, Congress tried to address the weak and deteriorated controls by making the installation and strengthening of controls the subject of many laws. For 200 years, Congress has held hearings, commissioned studies and entertained speeches and presentations before its committees regarding the importance of federal agencies having an integrated system of accounting and internal controls over financial reporting.

Until 2002 no law required that an independent audit and reporting be made of an entity’s internal controls over financial reporting. In July of that year, Congress, by the Sarbanes-Oxley Act, sent a clear, simple message to public corporations: “assess internal controls over financial reporting; audit internal controls over financial reporting.”

This study explores questions posed since the introduction of the 2002 law—would the application of Sarbanes-Oxley benefit the federal government’s internal controls and financial management? If so, might it be sooner rather than later? And if not, then when?

Section A

Federal Financial Controls: A Concern of Two Centuries

The record of congressional efforts to require the design, implementation and application of effective systems of internal financial controls over the receipts, expenditures and fiscal practices of the federal government is one of limited success. There have, however, been many attempts.

The 1800s and 1900s—Concerns Over Controls

While considerable in number, noting just a few of the laws that addressed the state of the federal government’s internal controls is illustrative of that history:⁴

- The *Act of 1789* founded the U.S. Department of the Treasury and established the government’s central accounting and reporting system. This is a system that today is still fiscally based, measures cash in and cash out and has limited value to congressional committees charged with overseeing federal programs or to federal executives charged with operating the programs and monitoring activities in compliance with laws.
- By the *Dockery Act of 1894*, Congress established a federal comptroller concept to implement changes in the federal government’s financial management practices, streamline the prior federal financial system, require a system of control checks and balances and improve the reporting of expenditures by congressional appropriations. Later record indicates that the state of federal controls did not improve.
- Forty years later, the *Budget and Accounting Act of 1921* established the U.S. General Accounting Office (GAO)⁵ and gave the comptroller general the authority to prescribe forms, systems of accounting and internal controls and procedures for the administrative control and management of federal expenditures. However, the ensuing years revealed that more federal agencies ignored GAO’s guidance than complied.
- In 1947, with the *Legislative Reorganization Act of 1947*, Congress again attempted to strengthen federal fiscal controls. Congressional hearings of the 1920s, 1930s and 1940s are replete with references to reports of commissions and institutes, special studies by Congress and the executive branch (such as those by Hoover, Brownlow, Brookings, Presidential Executive Orders) that document a continuing concern regarding the deteriorated state of federal financial management. Specifically noted, were references to the existence of deteriorated, weak or no internal financial controls at federal departments and agencies. Comprehensive evaluations of this act document a general conclusion that the act of 1947 was not successful in achieving its intended objectives.

AUDIT FEDERAL FINANCIAL CONTROLS:

- The *Budget and Accounting Procedures Act of 1950* promoted financial management initiatives anew, requiring, among many other improvements:
 - More effective controls over receipts, expenditures, funds, property and other federal assets
 - Executive agencies establish and maintain systems of internal controls, accounting and auditing
 - Executive agency systems of internal controls, accounting and auditing should provide full disclosure of the financial results of any agency activities and the effectiveness of its controls.

Throughout the 1950s and 1960s, GAO repeatedly reported to Congress a less than enthusiastic response by federal agencies to GAO's guidance.

- Almost 30 years later, the *Federal Managers' Financial Integrity Act of 1982* required of each federal agency to establish systems of internal administrative controls and accounting in compliance with standards by the comptroller general. The act also required that agency heads report to the president and Congress if material weaknesses are identified in an agency's systems of internal administrative controls and accounting.
- Seven years later, in a scorecard on the 1982 act, GAO told Congress that some agencies had some success in correcting weaknesses in internal controls; however, overall efforts to implement the act had not produced the results intended and the federal government generally did not have the internal controls to effectively manage federal programs.

The 1990s—A Decade of Laws

The number of laws enacted in the single decade of the 1990s, with respect to financial systems and controls, exceeded that of any decade in the preceding 200 years. The Chief Financial Officers Act and Federal Financial Management Improvement Act were typical of the legislated changes attempted in the 1990s.⁶

Chief Financial Officers Act—1990

The Chief Financial Officers (CFO) Act of 1990 required for the first time in the country's history that federal agencies prepare annual financial statements and that these statements be independently audited. Other mandates of the act stated that integrated agency accounting and financial management systems were needed to ensure compliance with internal control standards and policies, to provide consistent control over data entry, transaction processing and reporting and to eliminate unnecessary duplication of transaction entries.

The CFO Act culminated a long journey by Congress, presidents, federal financial executives and interested citizens. For decades, laws had been passed, executive orders issued, regulations released by the Treasury department and OMB and hundreds of reports issued by GAO and offices of federal inspectors general. All urged federal agencies to budget carefully, spend frugally, perform efficiently, measure results, accurately report and have systems of

internal controls over the expenditure of public funds. But a pattern of widespread noncompliance by agencies to install and operate effective systems of internal controls was typical in these years.

The CFO Act required that integrated agency accounting and financial management systems be developed and maintained, and that they include internal controls to ensure:

- Compliance with applicable accounting principles, standards, requirements and internal control standards
- Compliance with policies and procedures of OMB relative to accounting, auditing, reporting, internal controls and other areas of financial management
- Preparation, on a uniform basis, of complete, reliable, accurate, consistent and timely information that is responsive to the financial information needs of agency management.

Federal government system requirements defined an integrated agency accounting and financial management system as one that coordinates previously unconnected functions to improve overall efficiency and control. To be integrated, a system must have four essential characteristics:

- Standard data classifications for recording financial events
- Common processes for processing similar transactions
- Consistent control over data entry, transaction processing and reporting
- A system design that eliminates unnecessary duplication of transaction entries.⁷

Federal Financial Management Improvement Act—1996

With the Federal Financial Management Improvement Act of 1996 (FFMIA), Congress emphasized that control standards and systems of control had not been uniformly implemented by agencies and that the financial management systems of federal agencies continued to be seriously deficient.⁸

Congress, in FFMIA, acknowledged that while efforts had been devoted to federal internal controls in past years, uniform control standards still had not been implemented as part of an agency's integrated financial management system. Reference was made to the failed fiscal practices of federal agencies, noting specifically that controls systems were not uniformly implemented, and that agency accounting practices did not accurately report federal government financial results or full costs of programs and activities.

To remedy the long standing federal agency controls problem, FFMIA required that agencies:

- Implement the federal government's standard general ledger "at the transaction level"
- Eliminate past practices such as manual cross-walks of data between accounts and systems and working paper and off-the-books adjustments that might never be formally posted to the records

SOONER RATHER THAN LATER?

- Cease over-reliance on cash accounting in lieu of the more complete accrual accounting recommended by the Federal Accounting Standards Advisory Board (FASAB).

The objective of the FFMIA was to have periodic federal financial statements and reports routinely flow from the underlying transactional documentation, to intermediate journals or registers, then to an agency's ledger accounts and ultimately into the audited financial statements of an agency. A primary objective was that the audited financial statements required by the CFO Act were to be the routine and automatic by-product of an effective system of internal controls.

Section B

Unfulfilled Expectations: the State of Federal Agency Controls

Achieving the expectations of the CFO Act and the FFMIA is integral to routinely producing data to efficiently and effectively manage federal government day-to-day operations and to provide "good numbers" to all. In fact, the comptroller general, on more than one occasion, has stated that this is still the "end game"—with systems and processes that routinely generate complete, reliable, accurate, consistent and timely information.

In the discharge of its responsibilities, GAO periodically examines and reports to Congress on a broad scope of financial, management, operational and other issues. The deteriorated, weak, ineffective and, at times, nonexistent controls within federal agencies have been the subject of GAO reports over numerous years. The control issues highlighted in this section of the study have been reported in recent GAO reports to Congress. Similar views and observations have appeared in earlier GAO reports and, in all likelihood, will continue to appear in the future.⁹

Federal Controls in 2000: A Dismal State

In providing a scorecard on the successes of the 1982 Federal Managers' Financial Integrity Act, GAO reported that efforts to implement this act had not produced the results intended by Congress. GAO stated in a 1989 report to Congress, that the federal government did not have the internal control systems necessary to effectively operate its programs and safeguard its assets. In addition, GAO reported that the federal accounting systems were antiquated and second-rate.

In 2000, GAO reported that auditors of 20 of the 23 CFO Act agencies, whose audited financial statements had been issued, did not comply substantially with federal systems requirements, federal accounting standards and/or the federal government's standard general ledger. With respect to the standard general ledger, 11 of 20 noncompliant agencies reported that their systems did not comply with the standard general ledger, the use of which was mandated governmentwide by OMB and the Treasury department years earlier.¹⁰ In this report, the Treasury department comments that preparation of the federal government's consolidated

financial report using the standard general ledger hampered those agencies that did not use the standard general ledger to record accounting events "at the transactions level," as mandated by the FFMIA. Also noted by GAO were observations such as:

- Fifteen of the 20 noncompliant agencies reported problems complying with one or more federal accounting standards
- Executives of federal loan programs were unable to make reasonable estimates of costs of loan programs because financial systems were not able to capture historical borrower information such as early payment, late payment, defaults and at what points in time
- Noncompliance with the standard general ledger "at the transaction level" and federal accounting standards precluded agencies from capturing cost by major federal programs
- Without the facts, reliance was placed on data calls for outstanding receivables due to the government and information from the data calls was, in turn, posted to the agency's general ledger at the summary level (the actual transaction level data did not exist).

GAO observed that years after the enactment of the authorization and appropriation of FFMIA, federal agencies were still plagued by serious internal control deficiencies. A few reported examples included:

- The lack of cost accounting information limits Congress' ability to meaningfully evaluate agency management and program performance
- Federal agency executives cannot be sure that public funds are spent for legislated results and mandated outputs, or that waste and inefficiencies are minimized
- Information security weaknesses are a primary cause of systems and controls noncompliance and an even bigger concern for federal agencies and the public
- Virtually all of the larger federal agencies have significant computer security control weaknesses
- Enormous amounts of federal assets are at risk of inadvertent or deliberate misuse; financial information is at risk of unauthorized modification or destruction; sensitive information is at risk of inappropriate disclosure; and critical operations are at risk of disruption
- Inadequate segregation of duties to ensure that personnel do not conduct unauthorized actions without detection.

In 2002, GAO reported (GAO report, No. GAO-02-791T) that FFMIA assessments of recent years by federal inspectors general showed that the problems of past years continued to plague their agencies. This was an indication that overall agency management lacked the full range of information needed for accountability, performance reporting and effective decision-making. The report concluded that there was little evidence of marked improvements in federal agency capacity to create the full range of information needed to manage their agencies from an effectively controlled financial system.

AUDIT FEDERAL FINANCIAL CONTROLS:

According to GAO, the trend of noncompliance was indicative of the long-standing weak condition of agency financial systems due to the age and poor condition of critical systems. GAO underscored a basic fact that these aged “legacy” systems cannot and will never provide reliable financial information. Only a few agency systems even meet the newer governmentwide initiatives relative to integrating and reporting costs, budget and performance information.

Ineffective Controls, But “Clean” Audit Opinions

The overall status of internal controls over federal financial reporting is not good. GAO says, with justification, that the financial systems of most federal agencies continue to be noncompliant and fall short of the goals of the CFO Act and the FFMIA to provide reliable, timely, useful data for day-to-day management.

At the same time, however, GAO noted that an increasing number of agencies were obtaining “clean” or unqualified audit opinions on their financial statements. The number of agencies with noncompliant accounting and control systems receiving “clean” or unqualified audit opinions as of June 2000 follows:

- Fiscal Year 1999 14 of 23 CFO Act agencies
- Fiscal Year 1998 12 of 23 CFO Act agencies
- Fiscal Year 1997 11 of 23 CFO Act agencies.

An audit of a financial statement is not simultaneously an audit of an entity’s internal controls over financial reporting. Members of Congress, senior agency executives, interest groups, the media and citizens who are not financial managers, but who may use federal financial statements, could be misled about the true status of an agency’s financial capabilities, the reliability of its underlying systems of controls and the overall veracity of its accounting and reporting. However, neither *generally accepted auditing standards* nor *government auditing standards* require that an audit be made of the effectiveness of an agency’s internal controls as a prerequisite to the issuance of a “clean” audit opinion on an entity’s financial statements; nor does either set of auditing standards require that the auditor express an opinion on the effectiveness of a federal agency’s internal controls.

Under either set of audit standards, federal agencies can obtain “clean” audit opinions on their financial statements even though the auditor may have placed limited, or even no, reliance on the agency’s internal controls over financial reporting. When faced with an environment of weak, deteriorated or ineffective controls, independent auditors are permitted, under contemporary audit standards, to alternatively perform additional audit procedures to compensate for questionable controls to reach an opinion on the financial statements.

Section C

Agency Financial Statements: Not the By-products of Systems

Financial Statements: Compiled vs. Routine

In recent years, GAO has described financial statement compilation practices of agencies attempting to comply with the CFO Act as “heroic,” but with little evidence of marked improvement in underlying financial controls or the operational data for management.

In an attempt to meet the mandates of the CFO Act, some agencies have instituted time-consuming, labor-intensive practices to compile the required annual financial statements. These efforts include ad hoc programming and analysis of data produced by inadequate financial and control systems which are not integrated or reconciled. Often, these systems require significant audit adjustments. Where such practices prevail, an agency’s core accounting and control systems cannot be the primary source of information used to prepare the financial statements submitted for independent audit. This approach of off-line, year-end compilations of financial statements, in lieu of reliance on effective systems of internal controls, does little to engender confidence in the completeness, reliability, accuracy, consistency and timeliness of underlying data or the balances appearing in an agency’s financial statements and reports. In addition, this approach can mislead Congress, the president and the public about the true status of an agency’s management capabilities, the reliability of its underlying systems of internal controls, accounting and financial reporting, and the veracity of financial data released by a federal agency.

Pursuant to the CFO Act, 24th federal agencies are required to prepare and have independent audits made of their agencywide financial statements. As noted, these required financial statements are not a routine by-product of effective systems of internal controls. Instead, the statements are “compiled” off-system, manually and laboriously, and at considerable cost to human and automated resources. The mandated annual audited financial statements are a significant component of the accounting and financial reporting long sought by Congress. However, a once-a-year authentication of an agency’s financial statements, which are not a routine by-product of an effective system of controls, seems insufficient and not truly responsive to objectives concerning federal accounting and controls.

Until Sarbanes-Oxley, No Policy to Audit Controls

Until the passage of the Sarbanes-Oxley Act, no law or federal policy required that, concurrent with year-end audits of financial statements, an audit also be made of the effectiveness of an entity’s system of internal controls.

In the CFO Act, Congress required that federal agencies prepare annual financial statements and have these statements independently audited. This was a significant, but not absolute, response to the federal government’s financial

SOONER RATHER THAN LATER?

management issues. Financial statement audits are assertions of an agency's financial position and the results of operations "as of" a specific time, usually "as of" September 30, the last day of the federal agency's fiscal year. Agency financial transactions, however, are not recorded in a single batch "as of" September 30. Rather, financial transactions are inputted, processed, compiled and accounted for every day of the year and may be done pursuant to systems of controls, which are often less than effective.

By Congress—For over two centuries, Congresses have held hearings, required studies and received much testimony to the importance of federal agencies having an integrated system of accounting and internal controls over financial reporting. Congress has received reports and federal financial executives have been made aware that given the deteriorated condition of federal internal controls, with very few exceptions, independent auditors place minimal or no reliance on an agency's internal controls. Yet, at this time, no federal law requires that an audit be made of the operational effectiveness of a federal agency's internal controls over financial reporting.

By GAO—Comptrollers general, for more than 50 years, have supported the thesis that effective systems of internal financial controls are important from several viewpoints: management control, congressional oversight and public accountability. At this time, however, *government auditing standards*, first issued in 1972, do not require that independent audits be made of federal agencies' internal controls.

By OMB—For many years, federal financial policies, as expressed in OMB Bulletins and Circulars, have required that audit reports state whether an agency's financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards and with the government's standard general ledger at the transaction level. OMB had directed federal agencies to design, implement and adhere to internal financial controls in an effort to provide reasonable assurance of compliance with objectives such as: reliability of financial information; compliance with applicable laws and regulations; and reliability of performance reporting. At this time, however, OMB's policies do not require that an independent audit be made of a federal agency's internal controls over financial reporting.

By FASAB—Since its founding, FASAB has maintained that effective controls are necessary to ensure certain essentials of public accountability. FASAB's accounting and financial reporting concepts presume that an agency's accounting and financial reporting is a routine by-product of an integrated financial management control system. FASAB considers an agency's management control system to be a necessary prerequisite for effective management, continuous monitoring of operations and for issuance of timely, useful and accurate reporting of financial information. At this time, however, FASAB's concepts and standards do not refer to an annual independent audit of a federal agency's internal controls over financial reporting.

Controls: Concerns, But...

The timeliness, adequacy and operating effectiveness of federal agency internal controls has been a concern throughout the country's history. Congressional hearings, hundreds of GAO audits and a number of examinations by federal inspectors general, document a history of the poor, deteriorated and sometimes nonexistent, controls, and less-than-optimal operating effectiveness of internal controls within most agencies.

The deteriorated conditions of agency controls were brought into sharper focus with the passage of the CFO Act, which required, for the first time in the country's history, that federal agencies prepare annual financial statements and have these financial statements independently audited. As noted, federal agencies have responded in part to the objectives of the CFO Act by struggling to compile their financial statements off-system. Many federal agencies' existing internal controls over financial reporting have been, and continue to be, considered ineffective and incapable of meeting the objectives of the CFO Act or FFMIA.

Through the years, it has become clear that agency financial statements and reports, products of aged financial systems, are viewed with minimal or no confidence. The weakened, deteriorated or, in some cases, nonexistent controls have been a plague over the financial reporting and public accountability of federal agencies from the time of the first Congress. The subject has been much discussed, much reported and much legislated, but never resolved.

Section D

Controls Important, But Not Many Audited

For those lacking "insider" access to a federal agency's databases and underlying records, the annual audited financial statements mandated by the CFO Act are a significant contribution to the accounting and financial reporting long sought by Congress, senior agency management, public interest groups and interested citizens. However, within the CFO Act, is the presumption that required annual financial statements would flow from, and be a routine by-product of, sound systems of internal controls. Years have shown that this is not a reality.

"Outsider" constituencies that use the data found in federal financial statements need confidence that the reported numbers are the products of controlled financial systems, and that the numbers published by federal agencies are, in fact, "good numbers." Annual audits of internal controls over federal financial reporting, concurrent with the audit of an agency's financial statement, could provide that assurance. It would also send a message of confidence to parties external to the agency, that someone cares about and pays attention to how federal funds are committed, spent, applied, recorded and reported.

AUDIT FEDERAL FINANCIAL CONTROLS:

Controls: Most Agencies Do Not Audit

The wording in the audit reports of several of the 24 CFO Act agencies is emphatic, stating: agency controls were not tested; the purpose of the audit was not to audit controls; and/or no audit opinion is being provided on controls. The following excerpts from some federal financial statement audit reports are illustrative:

Agency #1: "In planning and performing our audit, we considered internal controls over financial reporting... we **did not** test controls defined by the Federal Managers' Financial Integrity Act of 1982. The objective of our audit **was not** to provide assurance on internal controls over financial reporting. Consequently, we **do not** provide an opinion thereon."

Agency #2: "In planning and performing our audit, we considered internal controls over financial reporting. We limited our internal control testing to OMB Bulletin 01-02. ...We **did not** test all controls relevant, as defined by FMFIA of 1982. The objective of our audit **was not** to provide assurance on internal controls over financial reporting. Consequently, we **do not** provide an opinion thereon."

Agency #3: "We **did limited testing** to achieve objectives in OMB Bulletin No. 01-02 and the Government Auditing Standards. ...**Did not** test all controls defined by the FMFIA of 1982. The objective of our audit **was not** to provide assurance on internal controls over financial reporting. Consequently, we **do not** provide an opinion thereon."

As further required by OMB Bulletin No. 01-02, with respect to RSI information... we obtained an understanding, ...assessed control risk, ...performed tests... The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion thereon."

Controls: If Audited, Criteria Not Uniform

In recent years (FY 2002, 2003), some federal agencies had aspects of their controls audited. As these audit efforts were voluntary, the audit coverage obtained and the resulting audit reports were not uniform. The scope of these control audits was determined by the individual contracting federal agencies.

At the March 2004 Joint Financial Management Improvement Program (JFMIP) conference, the accounting firm of KPMG reported on a survey it made of audit reports for the 24 federal agencies covered by the Chief Financial Officers Act. The KPMG survey confirmed the lack of uniform audits of controls, noting that several agencies subjected their controls to some type of audit coverage, but the nature of the described controls and compliance criteria differed.

KPMG reported that during 2002 and 2003, of the 24 agencies cited in the Chief Financial Officers Act:

- Eleven of the 24 CFO Act agencies reported audits of control and received an auditor's opinion on their internal controls.

- Three of the 24 agencies had control audits in 2002; eight other agencies audited controls in 2003.
- Of the 11 agencies reporting audit opinions on their internal controls, KPMG found that the audit reports for three agencies contained management's assertion on the effectiveness of internal controls.
- Audit reports for eight agencies stated that the audit opinions were effective "as of" the fiscal year-end.
- Audit opinions for three audits of controls were effective "as of" and "for the year ended."
- Thirteen of the 24 CFO Act agencies reported no audit of internal controls.

The KPMG survey also noted the audit opinions related to the 11 agencies referenced varying internal controls criteria, for example:

- Audit opinions for two agencies referenced GAO standards of internal controls.
- Audit opinions for three agencies referenced FMFIA criteria.
- Audit opinions for two agencies referenced controls criteria in OMB's Bulletin 01-02.
- Audit opinions for three agencies referenced controls criteria in both the FMFIA and OMB Bulletin 01-02.
- One agency's opinion referenced a management directive, similar to criteria in the FMFIA.
- Again, 13 of the 24 CFO agencies reported no audit of internal controls.

Section E

Computers, System Complexities Complexity: Controls Do Not Get Easier

Modernization and Integration: An Increased Need to Audit Controls

The accounting and reporting on the finances of government is a primary requirement of all federal financial systems and is no small feat. If effective systems of internal financial controls do not exist, are weak or are ignored altogether, agency accounting and reporting becomes a formidable task. Modernization efforts to address systems growth, complexities in accounting and make systems more "friendly," often seems to further aggravate conditions.

Increasingly over the years, in several federal agencies, management, agency operations and the accounting and reporting functions have been decentralized. Decentralization disperses authority and responsibilities for obligating the government, authorizing disbursements, spending federal resources and recording the financial effects. To meet the challenge, computer systems are continually streamlined and data processing accelerated. Innovations are introduced into systems operations, such as the remote, onsite, real time input of data by some who are not accountants and work hundreds or thousands of miles

SOONER RATHER THAN LATER?

from program managers. In this environment, layers of personnel and processes, manual and automated, surround any given financial transaction, and can cause even the most diligent managers to lose a sense of perspective and personal responsibility for the outcome.

Clearly, with technology there is the potential to benefit from increased effectiveness and efficiency, but only if relevant and effective internal controls are installed and applied to every transaction, every day. However, computerized systems also present all new and different types of control risks. These risks must be factored into an agency's internal controls and systems of "checks and balances." Some of the more common computer-related control risks (as identified by the American Institute of Certified Public Accountants) include:

- Inappropriate reliance on systems or software programs that inaccurately process data, process inaccurate data or both
- Permitting unauthorized access to data and improper changes to data, including recording of unauthorized or nonexistent transactions or inaccurate recording of transactions
- Allowing unauthorized changes to computerized data in master files and systems or software operating programs
- Failure to make necessary changes to computer systems or software programs
- Inability of professional and technical personnel to obtain the needed skills development and maintenance to ensure their continued systems competence
- Permitting inappropriate manual intervention and reliance on "cuff records," spread sheets and off-system reconciliations of data, the financial effects of which are often not formally recorded in agency registers and ledger accounts
- Potential loss, with or without knowledge of this deficiency, of essential data.

While these risks are directly associated with public companies, examples of each issue can be found in the controls environment existing at many agencies. The extent and nature of the above control risks depend on the nature and characteristics of an entity's information system. For example, multiple users may access a common database of information and each could unknowingly affect financial reporting. In such circumstances, a lack of control at a user-entry point could compromise the security of the entire database, potentially resulting in improper changes to, or even destruction of data.¹²

When effective internal controls are not in place and not applied day in and day out to every transaction, minimal reliance can be placed on the resulting financial statements and reports. Annual audits of internal controls can send a message to parties external to an agency that someone is paying attention to the federal funds committed, spent, recorded and reported.

Effective Controls: New or Simply Revamped?

The system complexities and complications described above require that there be a controls system—an effective internal control system—to ensure that the dispersed operations of computer-based financial systems can produce complete, reliable, accurate, consistent and timely information. Continuous changes and improvements to systems environments and particularly increasingly enhanced computerized databases, aggravates the problem and heightens the need to revamp existing federal agency controls, where possible. Most likely, however, resolution will necessitate the design, implementation and application of entirely new controls.

The existing federal control environment is related, in no small part, to the aged and poor condition of the "legacy" systems operated by several federal agencies. Controls can be revamped and upgraded, and the efforts may marginally increase the effectiveness of the systems, but upgrading existing controls may not be adequate to address the complex systems of this decade and cope with the changed ways in which federal departments and agencies now do the public's business. To a degree, current control systems are an inheritance that date back to the late 1970s and early 1980s. Then, federal financial management was evolving from manual, paper-based financial systems to an automated environment, which, in its earliest phases, was essentially an acceleration of manual systems. "Punch cards" and data tapes improved the timeliness of data, but did little to improve the quality of data produced.

Many reports, studies and congressional committee hearings documented the widespread violations, breaches and gaps in controls of federal departments and agencies. These conditions led to the passage of the FMFIA, the issuance of OMB's Circular A-123, *Internal Control Systems* and then to the President's Reform 88 Program. As recently as a 2002 report, and even more recently in testimony in professional forums and before Congress, GAO concludes that legacy systems of agencies cannot and will never lead to uniform, accurate and consistent agency financial data. The avoided and possibly ignored truth is that achieving better controls ultimately depends on the design of new controls for a far different breadth of responsibilities than existed when current controls were initially implemented.

AUDIT FEDERAL FINANCIAL CONTROLS:

Section F

Sarbanes-Oxley: Assess Controls, Audit Controls

On July 30, 2002, with the passage of the Sarbanes-Oxley Act, Congress gave a pre-eminence to internal controls by mandating corporate reporting and a disclosure about internal controls that, until this act, was not much discussed. By this act, Congress now requires that:

“Each annual report submitted to the Securities and Exchange Commission by a publicly listed corporation is to contain an internal control report, which shall: ...state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and contain an assessment by management of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.” Sec. 404(a)

- and -

“With respect to the internal control assessment made by management, the public accounting firm that prepares or issues the audit report shall attest to, and report on, the assessment made by the management on the effectiveness of internal control.”

Sec. 404(b)

The Sarbanes-Oxley Act changed corporate governance and financial reporting and permanently altered the regulatory environment for publicly listed companies that had prevailed since the 1930s. This act created a broad, new oversight regime by prescribing specific procedures, steps and practices to address governance failures. It also codified new responsibilities for corporate executives, corporate directors, lawyers and accountants and regulators. Of particular relevance, is the fact that the act mandates new management reporting requirements relative to internal controls. Section 404 of the act underscores the importance Congress places on having effective internal controls over financial reporting and gives controls a prominence in future financial reporting that has not been the case, thus far, in either the private or public sectors.

Sarbanes-Oxley—Goals of Financial Internal Controls

The Sarbanes-Oxley Act requires that all publicly traded companies include, in their annual report to the Securities and Exchange Commission, a separate auditor’s report attesting to management’s assessment of the company’s internal control environment. The auditors must independently attest or audit, and independently opine on the operational effectiveness of a public company’s internal controls.

The new priority given to internal control over financial reporting is clear in the Public Company Accounting Oversight Board (PCAOB)¹³ Release No. 2004-001, wherein PCAOB stated that to achieve reliable financial statements, internal controls must be in place:

- To see that records accurately and fairly reflect transactions in, and dispositions of, a company’s assets

- To provide assurance that the records of transactions are sufficient to prepare financial statements in accordance with generally accepted accounting principles
- To provide assurance that receipts and expenditures are made only as authorized by management and directors
- To make sure that steps are in place to prevent or detect theft, or unauthorized use or disposition of the company’s assets of value that could have a material effect on the financial statements.

The stated position of PCAOB is that users of financial statements can have more confidence in the reliability of a financial statement if management demonstrates that it exercised adequate internal control over the bookkeeping, the sufficiency of books of accounts and records for the preparation of accurate financial statements, and adherence to rules about the use of company’s assets and the possibility of a misappropriation of company assets.

Similar criteria concerning controls can be found in the composite of 1990s legislation, which Congress enacted to improve the financial management of federal departments and agencies.

Management—Assess Internal Controls

Compliance with the Sarbanes-Oxley law requires that an entity’s management: establish and maintain adequate internal control structure; have and implement policies and procedures for governing their financial reporting; and then annually assess and report to the government on the effectiveness of their internal controls and procedures. From now on, an auditor’s report for the financial statements of an entity must also be accompanied by a separate report on controls that:

- Presents the scope of the auditor’s testing of the internal control structure and assessment procedures of the management
- Presents the findings of the auditor as a result of such testing
- Presents an evaluation by the auditor regarding whether such internal control structure and procedures include maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer
- Provides reasonable assurance that transactions are recorded, as necessary, to permit preparation of financial statements in accordance with generally accepted accounting principles
- Provides reasonable assurance that receipts and expenditures are being made only in accordance with authorizations of management and directors of the issuer
- Provides a description of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

The above list closely parallels federal policy objectives appearing in OMB Circulars and Bulletins of the 1990s.

SOONER RATHER THAN LATER?

The Securities and Exchange Commission, in May 2003, clarified that management's assessment of the internal controls over financial reporting include:

- A statement of management's responsibilities for establishing and maintaining adequate internal control
- A statement identifying the framework used by management to evaluate the effectiveness of the entity's internal control
- Management's assessment of the effectiveness of the internal control as of the end of the most recent year, including a statement as to whether or not the internal control over financial reporting is effective
- A statement by management that the accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the entity's internal control
- Any changes in internal control that materially affect or is reasonably likely to affect the entity's internal control
- An attestation report by the registered public accounting firm on management's assessment of the entity's internal control.

While these specifics do exceed explicit current law or written policy concerning federal agency management's involvement and responsibilities for an agency's controls, they probably do not exceed the responsibility for controls implicit in management's role.

Auditor—Audit Internal Controls

Standards proposed by PCAOB require independent auditors, with respect to a public company's internal controls over financial reporting, to:

- Review management's assessment of the company's internal control
- Form an opinion about management's assessment of the effectiveness of internal control
- Form an audit opinion relative to management's assessment of controls after having:
 - Evaluated the reliability of the process used by management to assess the company's internal control
 - Reviewed the results of tests performed by management, internal auditors, and others during the assessment process
 - Performed his/her own audit tests and attest to and report on the assessment made by management.

Thus, to comply with Sarbanes-Oxley, an independent auditor must separately audit the operational effectiveness of internal controls over financial reporting to be satisfied that management's assessment conclusion is correct and fairly stated. This requires that the auditor separately test and report on the effectiveness of controls over financial reporting. To comply, this requires the auditor to provide a separate audit and report of findings resulting from audit tests that include:

- An evaluation of whether the control structure and procedures are reasonably detailed to accurately and fairly reflect the transactions and dispositions of the assets
- Reasonable assurance that transactions are recorded, as necessary, to prepare financial statements in accordance with generally accepted accounting principles
- Reasonable assurance that receipts and expenditures are made only in accordance with authorizations of management and directors of the entity
- Descriptions of material weaknesses and any material non-compliance found on the basis of such tests
- An audit opinion on whether management's assessment of effectiveness of controls is "fairly stated."

Within the past few years, some of the CFO Act agencies have required that aspects of their internal controls be independently audited and opined concurrently with their financial statements. As noted elsewhere, as there is no governmentwide policy concerning audits of federal controls, the scopes and types of opinions resulting from these audits have varied somewhat by agencies.

One Integrated Audit, Two Audit Opinions

The Sarbanes-Oxley Act and its related implementation standards clearly require that the audit of controls is to be integrated with, not separate from, the audit of an entity's financial statements.

PCAOB Auditing Standard No. 2 explains that Congress desires that an *integrated* audit be made of the financial statements and internal control over financial reporting, noting that:

"Notwithstanding the fact that the two audits are interrelated, the integrated audit results in two separate objectives: (1) to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting; and (2) to express an opinion on whether the financial statements are fairly stated."

Thus, Auditing Standard No. 2 is a standard that: (1) addresses the work required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements; and (2) refers to the attestation of management's assessment of the effectiveness of the internal control as the audit of internal control over financial reporting.

PCAOB decided that the audits of controls and financial statements should be integrated because the objectives of, and work involved in performing, an audit of internal controls over financial reporting and an audit of an entity's annual financial statements are closely related.

Material Weakness—Qualified Opinion

The objective of an audit of internal control over financial reporting is to form an opinion as to whether management's assessment of the effectiveness of internal control over financial reporting is fairly stated in all material respects. The absence, according to PCAOB, of one or more

AUDIT FEDERAL FINANCIAL CONTROLS:

of several elements prescribed for management's assessment of the effectiveness of internal controls may result in modification of the standard audit opinion.

When reporting on its assessment of controls, management must disclose any material weakness in the company's internal control over financial reporting. The existence of one or more material control weaknesses precludes management from concluding that its system of internal control is effective. What constitutes a *material weakness* has been generally agreed to in law, government auditing standards, various GAO publications, OMB regulations and the guidance of individual federal agencies, whereby:

“reportable conditions in which the design or operation of internal controls does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material in relation to the principal financial statements or required supplementary stewardship information for the federal entities being audited, or which are material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.”

This definition of a material weakness is essentially the same definition appearing in the *general accepted auditing standards* of the American Institute of Certified Public Accountants and included, by reference, in the federal *government auditing standards*, promulgated by GAO.

Attest vs. Audit: Distinction Without Difference

The auditor's attestation of management's assessment of internal control is referred to by PCAOB as the “*audit of internal control over financial reporting*.” This audit of controls shall not be the subject of a separate audit, but is to be performed in conjunction with the audit of the entity's financial statements.

During proceedings relative to its Auditing Standard No. 2, PCAOB noted that some respondents drew a distinction between an attestation and an audit, suggesting that an attestation is a different type engagement, which involves a lesser amount of work than an audit. PCAOB responded, “this idea is erroneous.” The view of PCAOB is that an attestation engagement to examine management's assessment of internal control requires the same level of work as an audit of an entity's financial statements.

Section G

Integrated Controls Framework—Already Federal Policy

The Sarbanes-Oxley Act requires that management of a publicly traded company base its assessment of the effectiveness of the internal controls over financial reporting on a “suitable, recognized control framework established by a body of experts that followed due-process procedures to develop the framework.”

The guidance in PCAOB Standard No. 2 is based on the *Internal Control—Integrated Framework* developed by the

Consortium of Sponsoring Organizations (COSO) of the Treadway Commission in 1992. However, other suitable, possibly different frameworks, not containing exactly the same elements as COSO, may be used. PCAOB, however, cautions that these other frameworks should have elements that encompass all of the general COSO themes.

COSO Integrated Framework: It Works, It's Accepted

Since 1992, the Committee of Sponsoring Organizations' *Internal Control—Integrated Framework* (the *Framework*) has been cited as the controls criteria in federal laws, regulations, the rules of the Security and Exchange Commission, more recently, the Sarbanes-Oxley law and PCAOB rules. Additionally, the COSO Framework has long been referenced in both *generally accepted auditing standards* and *government auditing standards*.

In addition, laws, regulations, rules and audit standards explicitly or implicitly reference:

- COSO's definition of internal controls
- COSO's essential structural components of controls
- COSO's rationale for the need for a sound, implemented, applied effective system of internal financial controls.

COSO's *Internal Control—Integrated Framework* has become the controls standard for much of the business world. Acceptance of COSO control guidance and criteria is pragmatic. COSO control concepts have been tested by many, applied in thousands of audits over its 12-year existence, and has been accepted by even more private and public sector organizations as their controls framework.

COSO: Control Definition and Components

As used by the Committee of Sponsoring Organizations,¹⁴ internal controls are broadly defined as:

“a process, effected by the governing board, management and other personnel of an audited entity, that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of controls in operations*—refers to an entity's performance, financial goals, and safeguarding of entity resources
- *Reliability of financial reporting*—refers to the preparation of reliable, published financial statements, including interim and condensed financial statements, and selected financial data extracted from such statements
- *Compliance with applicable laws and regulations*—that relate or apply to the audited entity.”

Under the COSO definition, internal controls encompass or consist of five interrelated structural components:

- *Control environment*—the environment “sets the tone” of an organization, provides the discipline and structure and is the foundation for all other components of internal control
- *Risk assessments*—identification, analysis and assessment of the relative risks to achievement of entity objectives

SOONER RATHER THAN LATER?

- *Control activities*—the policies, procedures and practices that help ensure management directives are carried out, including a range of activities as: approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties
- *Information and communication*—the information systems that produce reports containing operational, financial, and compliance related information that make it possible to administer, control and manage an organization's performance
- *Monitoring*—the periodic, regular, monitoring of systems of internal controls to assess the controls systems performance over a period of time that includes regular management, supervisory activities and other actions personnel take in performing their duties.

Internal controls criteria of federal laws, regulations, the rules of the Security and Exchange Commission, auditing standards of the PCAOB, GAO and AICPA, all reference COSO guidance as the standard or criteria for internal financial controls over financial reporting. COSO appears to have been adopted as the controls framework for the federal government.

COSO: Technology-Related Controls

With respect to *information technology related controls*, COSO identified two types of controls:

1. *General controls*—controls over:

- Data center operations (scheduling, backup, recovery procedures)
- Systems software controls (acquisition and implementation of operating systems)
- Access security
- Application system development and maintenance controls (acquisition and implementation of individual computer software applications).

2. *Application controls*—controls designed:

- to control information processing
- to help ensure the completeness and accuracy of transaction processing, authorization and validity
- to help ensure effectiveness of interface of applications.

Manual systems commonly rely on checks and balances, and prevention and detection procedures involving paper trails of transactions, such as signature authorizations, approvals, authentication of activities, reconciliations and follow-up of disclosed exceptions. Governments, however, will more than likely have information systems that, to some degree, use automated procedures to initiate, record, process and report transactions, in which case the electronic format replaces the paper "trail" and transactional evidence of past years. Computerized environments dictate that an emphasis also be given to general and application controls.

Automated environments require new thoughts about what constitutes effective control, the design and implementation of new controls, and requirements for additional

or alternative documentation and records. Computers, sophisticated software and the increasing reliance on databases affect and change the fundamental manner in which transactions are controlled, initiated, recorded, processed and reported. Sarbanes-Oxley requires that this controls process be assessed and audited.

COSO: Acceptance by Federal Agencies

Mention was made that among federal agencies, there is broad acceptance of COSO controls criteria, including its definition, its five interrelated structural components and 27 specific control sub-elements. Numerous laws, government regulations and federal accounting and auditing standards make reference to COSO's *Internal Control—Integrated Framework*, for example:

- AICPA—*Generally Accepted Auditing Standards*. As early as 1995, the COSO definition of internal controls, its structural components of an effective controls system and the COSO-specific control elements outlined in COSO's *Internal Control—Integrated Framework*, were incorporated by the AICPA into its generally accepted auditing standards.¹⁵
- OMB—*Federal Policy: Management Accountability and Control*. In 1995, OMB Circular No. A-123, Federal Management Accountability and Control, issued under the authority of the Federal Managers' Financial Integrity Act of 1982, places reliance on COSO's *Internal Control—Integrated Framework*.
- Congress—Federal Financial Management Improvement Act. The Federal Financial Management Improvement Act of 1996 incorporates the substance of COSO's *Internal Control—Integrated Framework*, specifically addressing several of the control elements highlighted in the COSO Framework.
- GAO—*Government Auditing Standards*. The 2003 revision of GAO's government auditing standards gave prominence to COSO's *Internal Control—Integrated Framework*, specifically identifying the five COSO structural control components as necessary to an effective system of internal controls over financial reporting.
- GAO—*Standards for Internal Control in the Federal Government*. GAO prescribes for federal departments and agencies essentially the same definition of controls, the structural components of an effective controls system and control elements delineated by COSO.
- OMB—Audit requirements for federal financial statements. OMB Bulletin 01-02, of October 2000 (that implements the audit provisions of the CFO Act, the Government Management Reform Act and the FFMIA) closely parallels the substance of COSO's *Internal Control—Integrated Framework*. It also adopts as federal policy the COSO definition of controls and references the AICPA's GAAS, which adopted in total COSO's *Internal Control—Integrated Framework*.

AUDIT FEDERAL FINANCIAL CONTROLS:

- PCAOB—Sarbanes-Oxley Act. This law requires the annual audit of management’s assertions relative to internal controls over financial reporting and an independent audit of the operational effectiveness of those controls and suggests using COSO’s *Internal Control—Integrated Framework* criteria.

Section H

Audit Federal Financial Controls: Sooner Rather than Later

The accounting and reporting on financial activities of the federal government is a primary and legal responsibility mandated by the Constitution itself. However, to this day, the state of the federal government’s internal controls over financial reporting concerns and perplexes Congress and those external to agency financial management.

When effective systems of internal financial controls do not exist, are weak, or are ignored altogether, accurate and timely agency accounting and reporting is a nearly impossible task. The task is made still more difficult as a result of natural systems growth and automation complexities and other innovations that attempt to make systems more “friendly.” Modernization seems to aggravate accounting and reporting and make these tasks more difficult.

Audit Controls, Send a Message

There is an important difference between Sarbanes-Oxley and all that came before. For the first time in the public or private sectors, public policy, with respect to internal controls, changed. Throughout the 19th century and all of the 20th century, federal laws, regulations and policies on accounting, financial reporting and auditing, all addressed internal controls by prescribing “criteria,” “guidance,” “assessments” and “reviews.” Some even required periodic reporting of deficiencies and weaknesses.

Until the Sarbanes-Oxley Act, no law or federal regulation required that internal controls over financial reporting be independently audited. Admittedly, Sarbanes-Oxley is directed toward publicly traded companies, however, the concerns expressed relative to internal controls over corporate financial reporting that preceded passage of this act, parallel congressional concerns over the effectiveness of federal financial internal controls. The concern remains: not much has been done to redress the continuing reports of “deteriorated,” “weak,” “nonexistent,” “deplorable” (and more congressional descriptors can be found in the public record) federal internal controls over financial reporting.

The first secretary of the Treasury expressed a concern of the country’s founders that is equally relevant today and which is part of federal financial policy:

“The purpose, limit and fund of every expenditure should be ascertained by a previous law... public security is complete if no money can be expended, but for an object, to an extent, out of a fund, which laws have prescribed. Alexander Hamilton, 1798

Two hundred years later, as noted by the comptroller general of the United States, the “end game” in 2004 is still the same:

“Federal processes and systems that routinely generate good information for day-to-day management purposes that when independently examined and provided to others—the president, Congress, heads of agencies, media and through them, citizens—will convey confidence that the ‘public security’ sought by that first Congress is complete.”

For federal entities that spend only public monies, independent audits of an agency’s internal controls would appear to be as important as an annual audit of financial statements. Quite possibly, audits of a federal agency’s financial controls deserve a prominence as great as, or greater than, audits of the agency’s financial statements.

Concurrent audits of internal controls would communicate to those without “insider” access to federal agency data that balances on an agency’s financial statements are complete, reliable, accurate, consistent and timely, and are the routine by-product of operationally effective systems of internal controls. Such a communication would send the message that numbers on the financial statements are, in fact, “good numbers.” Audits of controls would communicate a confidence in agency reporting important for congressional overseers, senior agency executives and interested citizenry. In the minds of many, that confidence in the government’s numbers is still very lacking.

Audit of Controls: Inevitable

Annual audits of internal controls over financial reporting, concurrent with the audit of an agency’s financial statement, tells parties external to the agency that someone cares about and is paying attention to how the federal funds are committed, spent, recorded and reported. The problems and issues addressed by the Sarbanes-Oxley Act appear equally applicable to the financial management of the federal government itself. Given its momentum, its stated purpose and governance goals that are similar to those Congress desires of federal agencies, the Sarbanes-Oxley law might well be imposed on the federal financial management community quickly and with minimal discussion. Should this happen, and if the past is any prologue, new laws will be passed and layered on duplicative past financial management legislation. More OMB and agency pronouncements and policy statements will be promulgated that overlap with much internal controls guidance of years earlier.

The existence of the Sarbanes-Oxley law creates a strong likelihood that congressional hearings in 2005 will be more focused on the auditing and reporting of federal financial controls than in years past. Also likely, is the fact that contributing testimony from *Fortune* 500 executives could be along the lines of: “If private companies must annually audit and report on controls, should federal agencies spending taxpayers’ money be permitted to meet a lesser standard of accountability?”

SOONER RATHER THAN LATER?

Speaking at the federal government's JFMIP annual conference in March 2004, William McDonough, chairman of the Public Company Accounting Oversight Board, implied that it would be very difficult for the federal government to avoid the same regulations that have been imposed on publicly traded companies.

If this is a plausible scenario for 2005, should the federal financial community, federal financial managers and federal inspectors general be the initiators? Failure to lead could likely result in wasteful, ineffective, sub-optimal regulations being imposed by law, on the advice of others less knowledgeable and far less experienced than contemporary federal financial managers.

Section I

Issues, Next Steps... Who Leads, Who Follows?

Federal agencies, while they earn no income, have a significant responsibility for accurate and timely accounting, controlling and reporting of the receipts, disbursements and applications of public monies. This responsibility creates peculiarities, differences and nuances required of federal agencies that might not be the same for those public companies required to comply with Sarbanes-Oxley.

Controls: Who Takes Initiative?

The federal financial management community, while there is time to influence and advise on the efficacy of Sarbanes-Oxley also becoming the federal government's internal controls policy, might begin that process by exploring:

- Whether Sarbanes-Oxley is applicable to the federal government? And if so, who in the federal government should make that evaluation?
- Should the essence, or all, or parts, or none of Sarbanes-Oxley be formalized as uniform, governmentwide, federal financial management policy? If so, who should take the initiative and make the determination?
- If not Sarbanes-Oxley, then what? Can the federal government do better and must it do better than the Sarbanes-Oxley law?
- Will costs to audit controls be a major consideration in comparison to the "benefit" of federal agencies not having equivalent or better numbers than private companies who are not spending the public's monies?
- Who in the federal government should take the initiative? Need it always be Congress or OMB? Might it be agency financial officers and inspectors general?

Leadership lag on the part of federal financial managers, relative to enhancing the effectiveness of federal controls, could likely result in wasteful, ineffective, sub-optimal policies and regulations being imposed by yet more laws and regulations on the advice of persons with far less knowledge and experience than contemporary financial managers. Recall that in 1985 when AGA and its members took the initiative in developing the study report entitled, *Strengthening Controllability in the Federal Government*,¹⁶ they

were instrumental in the development of the CFO Act of 1990.

Things to Ponder Sooner or Later

If change is inevitable and internal controls of federal agencies are to be audited and reported upon, now appears to be the time to start that initiative. Few, maybe none, are better positioned than agency financial officers and inspectors general to ensure an effective, meaningful application of the essence of Sarbanes-Oxley to federal financial management. No constituency is better suited to separate those aspects of the Sarbanes-Oxley law more suited to public companies and less suited to federal agencies.

Issues requiring further thought by the federal financial community might well include:

Cost—May Not be an Issue

Past initiatives to improve federal financial management have had to confront the "cost/benefit" issue. Audited controls will clearly cost more than simply the year-end audit of financial statements. On the other hand, with Congress's heightened awareness that laws calling for more effective controls have not been implemented and the fact that every company in America with publicly traded securities is now required to do what Congress asked of the federal government in the 1980s and 1990s, the cost/benefit issue might not be a major factor.

It is also difficult to defend the "benefit" of not having good or better numbers from federal government agencies that annually spend trillions of citizen dollars. Also, effective controls could significantly reduce the costs of many professionals in many federal agencies now devoted to the laborious compilation of federal financial statements because such statements are now not the routine by-products of integrated financial management systems. This labor-intensive process needed to prepare financial statements of federal organizations with budgets in the tens or hundreds of billions of dollars does not send a message of assurance or confidence that reported agency numbers are "good" numbers.

Controls Benchmark: COSO, the Federal Standard

If financial controls are to be audited, controls criteria or benchmark guidance will be required. As noted earlier, the Committee of Sponsoring Organizations' *Internal Control—Integrated Framework*, by default or otherwise, appears to have already become the federal standard.

The COSO criteria was recommended by the Treadway Commission of 1992 for corporate America, and seems to have found its way into the federal government's auditing standards, OMB policies and regulations, and other federal guidance publications. This *Framework* may be excellent guidance for federal agencies, although there may be peculiarities within the federal governments that deserve consideration as well.

Audit Reports—Remove the "Fog"

Fewer than half of the 24 CFO Act agencies have subjected their controls to any type of independent audit coverage.

AUDIT FEDERAL FINANCIAL CONTROLS:

The language of the resulting audit reports generally provides few clues as to what controls were specifically audited and the results of those audits, making such references as: “We limited our internal control testing to OMB Bulletin 01-02;” or “we limited our internal control testing to OMB Bulletin 01-02 and government auditing standards;” or “we did not test all of the controls defined by FMFIA of 1982;” or “we performed tests of compliance with FFMA Section 803(a) requirements.”

These types of audit assurances provide little information to members of Congress, senior agency executives and presumably to federal chief financial officers as to the message being conveyed. Recommendations from chief financial officers and inspectors general could contribute immensely to better communication and getting the message out to those not steeped in audit jargon or federal regulatory acronyms that have a right to be told in plain English which controls were audited, why and the results of those tests.

Timing of Audits: More Than “As Of” Year End

Financial statement audits are attestations of an agency’s financial position and results of operations “as of” a specific time, usually September 30, the last day of the federal agency’s fiscal year. The timing and audit periods of control attestations and audits required by Sarbanes-Oxley might also be examined. This law requires that both the financial statements and internal controls over financial reporting be audited “as of” an entity’s year end. But financial transactions are not recorded in a single batch “as of” September 30. Rather, transactions are inputted, processed, compiled and accounted for 365 days a year. What happens during the first 364 days of a year is as important and maybe more important than tests made of the year-end account balances “as of” September 30.

Who Participates, and To Do What?

The rote application of aspects of Sarbanes-Oxley to the federal government may not be appropriate.

Another area, in particular, is the official(s) required to assess and certify to the effectiveness of controls, and should this task be required of federal agencies. Under Sarbanes-Oxley, the chief executive officer of a public company is tasked with this responsibility. If this requirement were applied to the federal government, advice from federal financial executives would be invaluable as to whether the same level of official would be appropriate for a federal agency. Within the federal government, such an executive would likely be a presidential appointee. Continuity of occupancy, as well as limited expertise and knowledge of these appointees, could be more problematic in governmental organizations than it is for a public company. The controls assertion for a federal agency might have to be signed by other executive officials, such as the agency’s chief financial officer or inspector general.

Affecting this issue, according to the National Academy of Public Administration, is that historically senior federal executive leadership turns over, on the average, every 18 months.

Changing the Process: How? How Fast?

Should change be forthcoming relative to the audits of federal financial controls, beneficial guidance could be suggested by knowledgeable federal financial executives on how that change could be implemented. If the past is a prologue, with no intervention by federal financial executives, new requirements will be “layered” on top of the old.

The process could be much improved if a new law was passed that superseded overlapping conflicting legislation of past years and requiring governmentwide compliance with the new. On the other hand, a bill of “technical corrections” might suffice and eliminate months or years of congressional deliberations. Or, alternatively, since Congress, by Sarbanes-Oxley, has already spoken, a more expeditious alternative could be a Presidential Order that would achieve the same end, in weeks or a few months.

Still, none of these may be necessary if OMB, in consultation with federal chief financial officers and inspectors general, desired to issue a singular policy Circular to achieve uniform conformance across the government.

For sure, those that “sit and wait” will end up “sitting” and “waiting.” Others in the past, with far less experience and professional competence, have filled conceptual vacuums in governmental financial management that federal financial managers could have filled, but avoided.

On the other hand, AGA, having before been in this position to contribute, did contribute. Now might be the time to get in front of this new “parade” and do it again—and complete the job begun in 1985.

Fiscal year 2005 would be an excellent year to heed the advice, slightly paraphrased, of that “man of words” William Shakespeare, who said, “There’s a tide in affairs of government; take the current when it serves or lose the venture.”

Editor’s Note

The Department of Homeland Security (DHS) is the first agency required to have an audit of its internal controls over financial reporting. The DHS Financial Accountability Act (P.L. 108-330) requires DHS to have independent auditors render an audit opinion on its internal controls over financial reporting for fiscal years after fiscal year 2005. The law also mandates that the CFO Council and the President’s Council on Integrity and Efficiency jointly conduct a study of the potential costs and benefits of extending the requirement to all CFO Act agencies.

SOONER RATHER THAN LATER?

End Notes

1. The AGA task force for this report included: Robert Beuley, I.G., Department of Agriculture; Chuck Dempsey, I.G., HUD; Joseph Donlon, Senior Group Director, GAO; David Dukes, Assistant Secretary Finance, HHS and past Director of JFMIP; Roger Feldman, Comptroller, Department of State; Dennis Fischer, Deputy Assistant Secretary, HHS; Robert Harris, Deputy Assistant Director, CBO; Richard Kusserow, I.G., HHS; Cornelius Tierney, Partner, Arthur Young; Richard Willett, Partner, Alexander Grant. Titles reflect 1985 information.

2. In July 2004, a name change was approved by Congress for the "Government Accountability Office." This study, however, will refer to the General Accounting Office or GAO, as that title was used over the 80-year documented history of GAO and the congressional records of that period.

3. This research study was conducted by a team under the direction of AGA's project coordinator, Anna Miller, CPA, and included: Edward Kearney, CGFM, CPA; Roldan Fernandez, CGFM, CPA; and Cornelius Tierney, CGFM, CPA.

4. For a more detailed history of these years, please see the comprehensive analysis of proposed and enacted legislation concerning financial management, titled *Financial Management in the Federal Government*, Senate Document No. 11, prepared by the U.S. General Accounting Office for the Committee on Government Operations, United States Senate, 1961.

5. A name change was approved by Congress, in July 2004, to the "U.S. Government Accountability Office." This study will continue to refer to the General Accounting Office or GAO since that title used over the 80-year documented history of GAO and the congressional records of that period.

6. In addition to the Chief Financial Officers Act and the Federal Financial Management Improvement Act of 1996, other noteworthy financial management legislation of the 1990's included the Federal Credit Reform Act, Government Management Reform Act, Government Performance and Results Act, and Clinger-Cohen Act.

7. See GAO report No. GAO-02-791T, *Effective Implementation of FFMIA is key to Providing Reliable, Useful and Timely Data*, June 2002.

8. *Federal financial management systems* are defined to include internal financial controls, data, computer hardware, computer software, and competent and trained personnel.

9. U.S. General Accounting Office, *Financial Management: Agencies Face Many Challenges in Meeting the Goals of the Federal Financial Management Improvement Act*, report GAO/T-AIMD-00-1278, June 2000, Washington, D.C.

10. The standard general ledger promotes consistency in transaction processing and reporting through a vetted uniform chart of accounts and hundreds of illustrated pro-forma, standard transaction entries, each keyed to the ledger and sub-ledger accounts.

11. In 2004, the Department of Homeland Security (DHS), although not required to do so, prepared and submitted audited financial statements. The DHS Financial Accountability Act, signed into law in October 2004, applies the provisions of the CFO Act to the DHS.

12. American Institute of Certified Public Accountants, *AICPA Professional Standards; codification of U.S. auditing standards*, Section 319, N.Y., N.Y.

13. The Public Company Accounting Oversight Board was established by Congress to implement the Sarbanes-Oxley Act. Standards proposed by PCAOB must be subsequently approved by the Securities and Exchange Commission.

14. Based on a 1992 report by the Committee of Sponsoring Organizations, a consortium of cooperating organizations that included the Financial Executives Institute, American Institute of Certified Public Accountants, American Accounting Association, Institute of Internal Auditors and the Institute of Management Accountants.

15. The AICPA's GAAS was the governing audit guidance, through 2004, for audits of private sector entities and for public entities, having been incorporated by reference in the *government auditing standards* first issued by GAO in 1972.

16. The AGA task force for the study and that report included: Robert Beuley, I.G., Agriculture; Chuck Dempsey, I.G., HUD; Joseph Donlon, Senior Group Director, GAO; David Dukes, Assistant Secretary Finance, HHS, and past Director of JFMIP; Roger Feldman, Comptroller, Department of State; Dennis Fischer, Deputy Assistant Secretary, HHS; Robert Harris, Deputy Assistant Director, Congressional Budget Office; Richard Kusserow, I.G., HHS; Cornelius Tierney, partner, Arthur Young & Co.; Richard Willett, Partner, Alexander Grant. Titles reflect 1985 information.



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